In the Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-9

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

I

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RELEVANT DOCKET ENTRIES—TAX COURT
(Docket No. 1081-70)

Date	Filings and Proceedings
Feb. 25, 1970	PETITION FILED: FEE PAID Feb. 25, 1970
Feb. 25, 1970	REQUEST by petr. for trial at Kansas City, Mo.—GRANTED, Mar. 3, 1970
May 1, 1970	ANSWER filed by Resp.
Dec. 1, 1970	NOTICE OF TRIAL at Kansas City, Mo. on Feb. 22, 1971
Feb. 17, 1971	MOTION by Petr. for leave to file Amended Petition filed. (Amended Petition Lodged)—WITHDRAWN See Order 2/22/71
Feb. 22, 23, 1971	TRIAL at Kansas City, Mo. before Judge Scott Submitted on Feb. 23, 1971
Feb. 22, 1971	Hrg. on petrs. motion for leave to file Amended Petition withdrawn see Order Feb. 23, 1971 served.
Feb. 23, 1971	Stipulation of Facts w/exhibits BRIEFS due April 29, 1971 REPLY BRIEFS due May 25, 1971 SUBMITTED TO JUDGE SCOTT

Feb.	22, 1971	ORDERED: that petitioner's oral motion to withdraw documents is granted and petitioner's motion for leave of Court to file amended petition, filed Feb. 17, 1971, and petitioner's amended petition, lodged with the Court on Feb. 17, 1971 are hereby removed from the file and returned to petitioner's counsel.
Mar.	8, 1971	TRANSCRIPT of Feb. 22 & 23, 1971 received (2)
April	9, 1971	BRIEF for Respondent filed.
April	12, 1971	BRIEF for Petitioner filed (20-P)
May	24, 1971	REPLY BRIEF for Petitioners filed (20-P)
May	25, 1971	REPLY BRIEF for Respondent filed
Oct.	14, 1971	OPINION filed Judge Scott (Decision will be entered for respondent)
Oct.	18, 1971	DECISION entered Judge Scott

APPELLATE PROCEEDINGS

Jan.	3, 1972	ENTRY OF APPEARANCE of Ronald B. Stang for Petr.
Jan.	3, 1972	NOTICE OF APPEAL to U.S.C.A., 10th Cir., filed by Petr.
Jan.	3, 1972	NOTICE OF FILING with copy of Notice of Appeal served on Chief Counsel, Mr. K. Martin Worthy.
Jan.	3, 1972	NOTICE to parties of assembling and date for transmission of the record.
Jan.	3, 1972	CERTIFIED copy of notice of appeal was mailed to Clerk, U.S.C.A., 10th Cir.

Jan. 19, 1972 DESIGNATION of Charles White Hess and Ronald B. Stang as counsel to receive all service, filed.

Relevant Docket Entries—Court of Appeals

Case No. 72-1125

National Alfalfa Dehydrating & Milling. Commission of I.R.

Date	Filings—Proceedings	Filed
2-14-72	Cause docketed: record on appeal, Vol. I, Vol. II, III (transcript), Vol. IV (exhibits), orig. (over 300 pp.); docketing statement, orig. & 3 cc.	
	Order—assigned to General Calendar; appellant's brief due 3-27-72—Lewis	
2-18-72	Appearance—Aplt—Hess, Stang	
2-22-72	Appearance—Appellee—Rothwacks, Crampton	
2-28-72	Appearance—Appellee—Henkel, Jr., Frosch	
3- 8-72	Motion of Norton Simon, Inc. for leave to file brief amicus curiae—0 & 5cc-c/s	
3- 8-72	Motion of Norton Simon, Inc., for leave to file brief as Amicus Curiae Granted to File—Clerk-Rule 11 HKP	
3-27-72	Appellant's brief—25cc-c/s	
	Appendix—10cc-c/s	
	Exhibits to Appendix—4cc-c/s	
	Brief Amicus curiae—25cc-c/s (Norton Simon, Inc.)	
4-28-72	C.I.R.'s motion for ext. of time to and incl. 5-6-72 to file brief—0 & 3cc-c/s	
4-28-72	Order: C.I.R.'s motion for ext. of time *granted* to 5-6-72—BHS	
5- 5-72	Appellee's brief—25cc-c/s	
5-22-72	Motion of Norton Simon for leave to file reply brief as amicus curiae—0 & 3cc-c/ (to panel)	
	Reply brief for amicus curiae—25cc-(2cc sent to panel) c/c—rec. but not filed pending Appellant's reply brief—25cc-c/s *filed 6-6-72*	
6- 6-72	Order: Motion of Norton Simon, Inc. for leave to file reply brief as amicus curiae *granted*. (Lewis, McWilliams)	
7-27-72	Set for Hearing—Wichita, Kansas	
9-13-72	Argued and submitted—Phillips, Hill, Holloway	
11-24-72	Appellee's addtl. authority (Classn's, Inc. opinion) for argument—and letter—0 & 3 cc-c/s	
11-27-72	Appellant's response to addtl. authority for argument—0 & 4 cc-c/s	
11-27-72	Appellee's addtl. authority and Appellant's response forwarded to panel (Phillips, Hill, Holloway)	
12-14-72	Amicus Curiae's objection to Government's additional authority—0 only c/s (Fwd. to Panel)	

1–26–73	Opinion—Phillips, Hill, Holloway Judgment: Reversed and remanded in accordance with the opinion; Hill, Circuit Judge, dissenting
2–20–73	Mandate to Tax Court
3– 1–73	Receipt—Mandate
3– 2–73	Letter to panel re: record
3–13–73	ORIG ROA to Clerk, Volumes I thru IV
3–26–73	Receipt—ORIG ROA, Vols I thru IV
4–19–73	Copy of letter Granting extension of time to file a petition for writ of certiorari to 6–25–73
7– 3–73	Supreme Court Notice of Filing Petition for Certiorari, 6–25–73, 73–9

PETITION

(Filed February 25, 1970)

THE TAX COURT OF THE UNITED STATES

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY, Petitioner, vs. COMMISSIONER OF INTERNAL REVENUE, Respondent.	Docket No. 1081-70

PETITION

The above-named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (bearing symbols AP:KC:HWL:FMC:dDd-90D) dated December 17, 1969, and, as a basis of this proceeding, alleges as follows:

1. The petitioner, National Alfalfa Dehydrating and Milling Company, (hereinafter "National Alfalfa") is a Delaware corporation with its principal office at Cloverleaf 1 Building, 6811 West 63rd Street, P.O. Box 500, Shawnee Mission, Kansas 66201. The return for the period here involved, taxable year ended April 30, 1967, was filed with the District Director of Internal Revenue for the District of Kansas, Wichita, Kansas.

2. The notice of deficiency, a copy of which is attached hereto and marked Exhibit "A", was mailed to the petitioner on December 17, 1969.

3. The Commissioner determined a deficiency in the U.S. corporation income tax of petitioner for the taxable fiscal year ended April 30, 1967 in the amount of $147,-949.76 based upon a disallowance of the deduction for amortization of the discount on debentures of petitioner and based upon a recomputation of the net operating loss deductions of petitioner for taxable years ending April 30, 1958, 1959, 1960, 1961, 1962, 1963, 1964, 1965 and 1966 due to the disallowance of the amortized bond discount deductions for those years.

4. The determination of tax set forth in said notice of deficiency is based upon the following errors:

(a) The Commissioner erred in determining that petitioner, National Alfalfa, was not entitled to a deduction for amortization of the discount on debentures of National Alfalfa in the amount of $109,804.00 for the taxable year ended April 30, 1967, said disallowance of the deduction for that year being allegedly based on the fact that the difference between the face value of the bonds issued in 1957 for certain then outstanding cumulative preferred stock and the fair market value of the preferred stock on the date on which they were exchanged did not, considering the character of the exchange, constitute bond discount.

(b) The Commissioner erred in determining that petitioner, National Alfalfa, was not entitled to a portion of its claimed net operating loss carry-forward deduction for the taxable years ended April 30, 1958 through April 30, 1966 amounting to $321,657.00 because of the Commissioner's disallowance for said periods of the deduction for amortization of the discount on debentures of National Alfalfa, said disallowances of the deductions for said years being allegedly based on the fact that the difference between the

face value of the bonds issued in 1957 for certain then outstanding cumulative preferred stock and the fair market value of the preferred stock on the date on which they were exchanged did not, considering the character of the exchange, constitute bond discount.

5. The facts upon which the petitioner relies as the basis for this case are as follows:

(a) On July 23, 1957 the preferred stockholders of National Alfalfa agreed to exchange their $50 par value preferred stock in National Alfalfa for 18-year 5% sinking fund debenture bonds of National Alfalfa due in 1975. The exchange of the preferred stock for the debenture bonds was treated as a taxable exchange by the preferred stockholders, as required by Section 302(a) of the Internal Revenue Code of 1954, as amended, and as required by the U.S. Treasury Department in a ruling letter dated May 29, 1957, a copy of which ruling letter is attached hereto and marked Exhibit "B".

(b) At the time of the exchange there were 47,059 shares of 5% cumulative preferred stock of National Alfalfa with a par value of $50 per share issued and outstanding the fair market value of which was $33 per share which represented an aggregate fair market value of $1,552,947.

(c) National Alfalfa in accordance with action of its Board of Directors taken April 8, 1957 issued $2,352,950 of its 5% sinking fund debenture bonds due in 1975 in exchange for its preferred stock with an aggregate fair market value of only $1,552,947 and thus incurred bond discount amounting to $800,003. According to the Internal Revenue laws (Sec. 1.61-12 (c)(3) Income Tax Regulations) said discount was

deductible and properly amortizable over the life of the bonds. The deductions for the amortization of discount on the bonds were taken on National Alfalfa's tax returns for the taxable years 1958 through 1967 based upon the appropriate discount for bonds reacquired during each of said years as well as a prorated amount of discount for the bonds still outstanding at the end of National Alfalfa's annual accounting period.

(d) The deduction claimed for bond discount amortization by National Alfalfa in each respective year was as follows:

Year Ended	Amount of bond discount amortization
4/30/58	$ 37,037.00
4/30/59	63,377.00
4/30/60	59,317.00
4/30/61	28,743.00
4/30/62	41,813.00
4/30/63	27,751.00
4/30/64	52,186.00
4/30/65	60,071.00
4/30/66	25,900.00
4/30/67	109,804.00
	$505,999.00

(e) The 5% sinking fund debenture bonds due in 1975 issued in exchange for the preferred stock represented and represent valid and subsisting indebtedness in the original face amount of $2,352,950 within the meaning of the Internal Revenue laws and expressed an unconditional and legally enforceable

obligation to pay their face amount upon redemption on the part of National Alfalfa.

(f) The determinations of the Commissioner set forth in Exhibit "A" attached hereto, are arbitrary, discriminatory and in total disregard of the applicable Internal Revenue laws (Sec. 1.61-12(c)(3) Income Tax Regulations) in that the petitioner, National Alfalfa, properly deducted on its U.S. corporation income tax returns in all the years in question the appropriate amount of bond discount amortization to which it was entitled under the foregoing facts and applicable federal income tax laws, and since the Commissioner improperly disallowed in the years in question portions of petitioner's net operating loss carryforward attributable to the deduction for amortized bond discount in each respective year.

6. Wherefore the petitioner prays that the Court hear the proceeding and:

1. Determine that the Commissioner erred as alleged in each assignment of error set forth in paragraph 4 above.

2. Determine that the petitioner was and is entitled to the deduction for amortization of bond discount with respect to the debenture bonds for each year in question.

3. Determine that the petitioner is entitled to the portions of its net operating loss carry-forward disallowed by the Commissioner for the years in question.

4. Find that there is no deficiency in the corporate income tax of petitioner for the year 1967.

5. Give such other and further relief as the Court may deem proper.

/s/ James J. Melching
James J. Melching
/s/ Charles W. Hess
Charles W. Hess
3rd Floor-Columbia Union
National Bank Building
Kansas City, Missouri 64106
HA 1-6388
Counsel for Petitioner

STATE OF NEBRASKA)
) ss:
COUNTY OF HOLT)

Charles R. Peterson, President of National Alfalfa Dehydrating and Milling Company, petitioner in the foregoing Petition in the Tax Court of the United States, being duly sworn, says that he has read the foregoing petition, or has had the same read to him, and is familiar with the statements contained therein, and the statements contained therein are true, except those stated upon information and belief, and those he believes to be true; that he is duly authorized as President of Petitioner to verify the foregoing petition.

/s/ Charles R. Peterson
President
National Alfalfa Dehydrating
and Milling Company

Sworn to and subscribed before me this 3 day of Feb., 1970.

/s/ William J. Edwards

[Seal]

My Commission Expires: Jan. 19, 1972.

Exhibit A

P.O. Box 13606, Commerce Post Station, Kansas City, Mo. 64199

US Treasury Department

Regional Commissioner
Internal Revenue Service
Midwest Region

Date: DEC 17 1969 | In reply refer to: M:C:P:AM:Gardner:JD

National Alfalfa Dehydrating and Milling Company
Cleveland & Lathrop
Gill Unit (Old Forest, P.O. Box 503)
Excelsior Springs, Missouri 64024

Gentlemen:

Taxable Year Ended	Deficiency
April 30, 1967	$147,049.75

This letter is to notify you--as required by law--that we have determined the income tax deficiencies shown above. I regret we have been unable to reach a satisfactory agreement in your case. The enclosed statement shows how the deficiencies were computed.

If you do not intend to contest this determination in the Tax Court of the United States, please sign and return the enclosed waiver form. This will permit an early assessment of the deficiencies and limit the accumulation of interest. The enclosed pre-addressed envelope is for your convenience.

If you decide not to sign and return the waiver, the law requires that after 90 days from the date of this letter (150 days if this letter is addressed to you outside the United States and the District of Columbia) we assess the deficiencies and take action to collect the tax. However, if within the time stated you contest this determination by filing a petition with the Tax Court, we may not assess any deficiencies for these years until after the Tax Court has decided your case.

You may obtain a copy of the rules for filing a petition with the Tax Court by writing to the Clerk, Tax Court of the United States, Box 70, Washington, D. C. 20044.

Sincerely yours,
[illegible]
Commissioner
By
/s/ Albert E. Tager
Albert E. Tager
Chief, Appellate Branch Office

Enclosures:
Waiver, Form 870
Statement
Pre-addressed envelope

Form L-31A (Rev. 6-69)

Form 4089 (January 1961)	U.S. TREASURY DEPARTMENT - INTERNAL REVENUE S.	CE	SYMBOLS: AP:EC:MTL:EJC: dcd-209
	STATUTORY NOTICE STATEMENT		

National Alfalfa Dehydrating and Milling Company
Cloverleaf I Building
6811 West 63rd Street
P.O. Box 500
Shawnee Mission, Kansas 66201

KIND OF TAX		
Income		
TAXABLE YEAR ENDED		DEFICIENCY
April 30, 1967		$147,949.76

☒ Copy to Authorized Representative: Mr. James H. Weiner
2900 Commerce Tower
Kansas City, Missouri 64199

[-2-]

Form 3613 (Rev. December 1967)	U.S. TREAS. DEPARTMENT - INTERNAL REVENUE SERVICE CORPORATION INCOME TAX	STATEMENT [illegible]

NAME	TAXABLE YEARS ENDED		
National Alfalfa Dehydrating and Milling Company			April 30, 1967
TAXABLE INCOME AS SHOWN IN:	$	$	$
☒ RETURN AS FILED			124,499.80
☐ PRELIMINARY LETTER DATED			
☐ STATUTORY NOTICE DATED			
INCREASES-(DECREASES) IN INCOME (See attached explanation of items)			
(a) Credit for non-highway use of gasoline			3,062.22
Taxable income to which you have qualified acceptance by execution of Form 870			127,562.02
(b) Amortization of discount on debentures			109,804.00
(c) Net operating loss deduction			321,657.00
TAXABLE INCOME AS REVISED	$	$	$559,023.02
LESS: EXCESS OF NET LONG-TERM CAPITAL GAIN OVER NET SHORT-TERM CAPITAL LOSS			
INCOME SUBJECT TO TAX	$	$	$559,023.02
PARTIAL TAX	$	$	$261,831.05
ADD: 25% OF EXCESS SHOWN ABOVE			
SUBTOTAL	$	$	$261,831.05
OTHER (ADDITIONAL SURTAXES, CREDITS, ETC.)			
Investment Credit			77,849.27
INCOME TAX LIABILITY	$	$	$183,981.78
INCOME TAX PREVIOUSLY ASSESSED			
Original return - DLN 463122009003			34,981.98
Additional - DLN 4634729300200			1,050.04
DEFICIENCY (OVERASSESSMENT)	$	$	$147,949.76

TAX COMPUTATION

National Alfalfa Dehydrating and Milling Company

Statement

Taxable Year Ended April 30, 1967

Explanation of Adjustments

(a) This represents an adjustment to which you have previously signified acceptance by execution of Form 870 and on which the tax has been assessed.

(b) The difference between the face value of the bonds issued and the fair market value of the preferred stock on the date of the exchange does not, considering the character of the exchange, constitute bond discount and, thus, amortization thereof is not a proper deduction. Therefore, taxable income is increased $109,804.00.

(c) Since amortization of bond discount is not allowable as explained in adjustment (b), claimed amortization is eliminated in computing the net operating carryforward. Therefore, the net operating loss deduction is adjusted as follows:

As shown on return	$800,319.75
As revised, see Exhibit A	478,662.75
Increase in taxable income	$321,657.00

Other Adjustments

The investment credit is recomputed as follows:

Tax as recomputed (A)	$261,831.05	
Lesser of (A) or $25,000.00		$25,000.00
28.51664% of ($261,831.05 less $25,000.00)		67,642.83
Total		$92,642.83
Less 7% of suspension period property		14,793.56
Investment credit		$77,849.27

*Per preliminary letter

EXHIBIT 2

NATIONAL HEALTH LABORATORIES, INC. Milling Company

TAXABLE YEARS ENDED APRIL 30, 1962

COMPUTATION OF NET OPERATING LOSS DEDUCTION

	Y.E. 4-30-57	Y.E. 4-30-58	Y.E. 4-30-59	Y.E. 4-30-60	Y.E. 4-30-61	Y.E. 4-30-62	Y.E. 4-30-63	Y.E. 4-30-64	Y.E. 4-30-65	Y.E. 4-30-66	
TAXABLE INCOME OR LOSS BEFORE NET OPERATING LOSS DEDUCTION	(729,333.00)	(1,264,430.00)	257,890.00		75,262.00	(93,687.00)	466,384.00	1,151,178.00	(934,497.00)	229,792.25	
(a) ELIMINATION OF BOND DISCOUNT ADJUSTMENT	37,037.00	63,377.00	59,310.00		25,743.00	41,813.00	27,751.00	56,126.00	62,037.00	25,900.00	
(b) DEPRECIATION EXPENSE			59.00		5,182.00						
(c) VACATION PAY ACCRUAL									(1,775.00)		
TAXABLE INCOME OR LOSS AS REVISED	(692,296.00)	(1,201,053.00)	317,259.00		109,193.00	(51,874.00)	494,135.00	1,207,304.00	(874,335.00)	255,692.25	
ABSORPTION OF NET OPERATING LOSSES:											TOTAL
Y.E. 4-30-56			(44,672.00)								(44,672.00)
4-30-57			(272,587.00)		(109,193.00)						(381,780.00)
4-30-58							(201,053.00)				(201,053.00)
4-30-59							(191,562.00)	(1,009,991.00)			(1,201,553.00)
4-30-62								(51,874.00)			(51,874.00)
4-30-65								(141,999.00)		(255,692.25)	(397,691.25)
SUMMARY:											
NET OPERATING LOSS - Y.E. 4-30-65		876,354.00									
ABSORBED											
Y.E. 4-30-67	141,999.00										
Y.E. 4-30-66	255,692.25	397,691.25									
NET OPERATING LOSS DEDUCTION - Y.E. 4-30-67		478,662.75									

(a) and (c) These adjustments agree to the computation of net operating loss carryforwards as shown on returns.

Exhibit B

U. S. TREASURY DEPARTMENT
Washington 25

May 29, 1957

T:R:R
LGH

Mr. James J. Davis
1342-43 Fidelity-Philadelphia Trust
Building
123 South Broad Street
Philadelphia 9, Pennsylvania

Dear Mr. Davis:

This is in reply to your letter of April 17, 1957, written on behalf of the National Alfalfa Dehydrating and Milling Company, Lamar, Colorado, requesting a ruling as to the effect for Federal income tax purposes of a proposed recapitalization. Your letter of April 23, 1957, submitting additional information in regard to the matter has also been received.

National Alfalfa Dehydrating and Milling Company (hereinafter referred to as Company) was incorporated on May 4, 1946, under the laws of Delaware, to engage in the business of dehydrating and milling alfalfa. The balance sheet as of February 28, 1957, which was submitted discloses that there were outstanding 47,059 shares of 5% Cumulative Preferred Stock, par $50. per share, and 790,000 shares of Common Stock, par $1. per share. The Surplus Accounts were as follows:

Capital Surplus		$3,378,361.61
Earned Deficit		(257,180.91)
Operating Profit or Loss for Ten Months	$255,375.37	
Profit or loss on sale of Capital Assets	(380.27)	
Less Reserve for Federal and State Income Taxes	(12,000.00)	242,995.10
		$3,364,175.80

The dividend arrearage on the preferred stock will be $10.00 per share as of June 1, 1957.

It is stated that on April 8, 1957, the Board of Directors adopted a recapitalization plan under the terms of which the following stock and securities would be issued in exchange for all of Company's presently outstanding stocks:

Presently Outstanding	Stock and Securities to be Issued
47,059 shares 5% Cumulative preferred stock, par $50. per share	$2,352,950., 5% Debenture Bonds due 1975
Dividend arrearage on the 47,059 shares of preferred stock as of June 1, 1957—$10.00	Warrant to subscribe for 1/2 share of common stock of a par value of $3. per share at $10. per share
790,000 shares common stock, par value $1.00 per share	790,000 shares common stock par value $3.00 per share

The new debentures would be issued pursuant to an Indenture between Company and Fidelity-Philadelphia Trust Company, Philadelphia, Pennsylvania a page proof copy of which Indenture has been submitted and is incorporated herein by way of reference. Some of the

more important provisions are (1) the Debentures are direct obligations of Company, but are not secured; (2) the Debentures will be dated August 1, 1957, and are to mature July 1, 1975, and are to bear interest at the rate of 5% per annum, payable semi-annually on January 1 and July 1 in each year; (3) the Debentures are subordinate to all bank loans for inventory purposes and obligations of Company to suppliers of materials, services and labor incurred in the normal course of business; (4) the Debentures are redeemable at the option of Company, as a whole or in part, from time to time, on at least 60 days published notice after July 1, 1958, and prior to July 1, 1975, at 100% of par, plus accrued interest to the date of redemption; and (5) the Company will pay to the Trustees annually commencing 90 days after April 30, 1959, as and for a contingent sinking fund for the redemption of Debentures at 100% with interest accrued to the date fixed for redemption an amount which shall be the lesser of the sum sufficient to redeem $196,080. principal amount or an amount equal to 100% of the consolidated net earnings for the next fiscal year of Company. The Company will accrue 100% of its net earnings commencing on May 1, 1957, and set aside such sum to be able to meet the sinking fund provisions. If in any year 100% of the net earnings does not equal $196,080., such deficiency will accrue against future earnings of the Company and will be paid over to the Trustee in such future years in order that 1/12th of the entire amount of the issue will be retired for each year subsequent to April 30, 1959. The Company reserves the right to purchase in the open market Debentures for sinking fund purposes.

It was stated orally that The Securities and Exchange Commission has now given its approval. A vote of 66⅔% of each of the classes of stock is required under Delaware law to approve the recapitalization plan and it is expected

that such plan will be submitted to the stockholders at the annual meeting to be held on July 23, 1957.

The principal business reason for the recapitalization is the Company's expansion into eastern producing areas in February, 1957, which made its credit requirements at least 50% greater in order to carry increased inventories.

Based solely on the information submitted it is concluded as follows:

(1) The exchange by the holders of $1. par value common stock for $3. par value common stock, on the basis described above, will constitute a recapitalization and, therefore, a reorganization, within the meaning of section 368(a)(1)(E), of the Internal Revenue Code of 1954. No gain or loss will be recognized to Company as a result of the exchanges.

(2) No gain or loss will be recognized to the holders of common stock as a result of the exchange of common stock (section 354(a)). The basis to each stockholder of the stock received will be the same as the cost or other adjusted basis of the stock surrendered (section 358(a)). The holding period of the stock received will include the holding period of the stock surrendered in the exchange (section 1223)).

(3) Assuming but not determining that the 5% debenture bonds to be issued qualify as securities (create a genuine relationship of debtor and creditor), gain or loss will be recognized to the preferred stockholders from the exchange of 5% cumulative preferred stock, par $50., and the dividend arrearage thereon of $10. per share as

of June 1, 1957, for debenture bonds and warrants to subscribe for the new common stock at $10. per share (section 302(a)). The gain or loss recognized from the exchange will be measured by the difference between the cost or other adjusted basis of the preferred stock surrendered and the fair market values of the debentures and warrants received and such gain or loss will constitute capital gain or loss subject to the applicable provisions and limitations of Subchapter P Part I of Subtitle A of the Code.

The basis of the debentures and the warrants received by the holders of the old preferred stock will be the fair market values used in the determination of the recognizable gain or loss.

(4) The fair market values prevailing on the date the Plan is declared effective are the values to be assigned to the debentures and the warrants received in the exchange.

It is important that a copy of this letter be attached to the income tax return of each taxpayer involved filed for the year in which the transaction is consummated.

Very truly yours,

/s/ Frances B. Rapp
Chief, Reorganization and
Dividend Branch

ANSWER

(Filed May 1, 1970)

UNITED STATES TAX COURT

[CAPTION OMITTED]

ANSWER

THE RESPONDENT, in answer to the petition filed in the above-entitled case. admits and denies as follows:

1. to 3., inclusive. Admits the allegations contained in paragraphs 1. to 3., inclusive, of the petition.

4. (a) and (b). Denies the Commissioner erred as alleged in subparagraphs (a) and (b) of paragraph 4. of the petition, or in any manner.

5. (a) to (c), inclusive. Denies the allegations of fact contained in subparagraphs (a) to (c), inclusive, of paragraph 5. of the petition.

5. (d) Admits petitioner claimed bond discount amortization as set forth in subparagraph (d) of paragraph 5. of the petition.

5. (e) and (f). Denies the allegations of fact contained in subparagraphs (e) and (f) of paragraph 5. of the petition.

6. Denies generally and specifically each and every allegation of the petition not hereinbefore expressly admitted, qualified or denied.

WHEREFORE, it is prayed that the deficiency determined by the respondent be in all respects approved.

/s/ K. Martin Worthy
K. Martin Worthy
Chief Counsel,
Internal Revenue Service.

Of Counsel:
Frank C. Conley,
Regional Counsel,
David A. Pierce,
Attorney,
Internal Revenue Service,
2700 Federal Office Building,
Kansas City, Missouri 64106.

STIPULATION OF FACTS

(Filed February 22, 1971)

UNITED STATES TAX COURT

[CAPTION OMITTED]

STIPULATION OF FACTS

IT IS HEREBY STIPULATED THAT, for the pu poses of this case, the following statements may be a cepted as facts and constitute all of the facts in this ca and all exhibits referred to herein and attached here are incorporated in this stipulation and made a part here subject to the right of either party to object to the a mission of such facts in evidence on the grounds of m teriality and relevancy.

1. National Alfalfa Dehydrating and Milling Co pany (hereinafter referred to as National Alfalfa) is Delaware corporation with its principal office at Clove leaf 1 Building, 6811 West 63rd Street, Post Office Bo 500, Shawnee Mission, Kansas 66201. National Alfalfa wa duly incorporated on May 4, 1946 under the laws of Del ware to engage in the business of dehydrating and millin alfalfa.

2. Attached hereto and marked Exhibits 1-A throug 9-I are copies of Federal income tax returns filed by Na tional Alfalfa for its taxable years ended April 30, 195 through April 30, 1960 and April 30, 1962 through Apr

30, 1967, respectively. Also attached hereto and marked Exhibit 10-J is a photo copy of National Alfalfa's retained copy of the income tax return filed by it for its taxable year ended April 30, 1961 which is a true and accurate representation of the return filed by National Alfalfa for that fiscal year with the District Director of Internal Revenue.

3. Prior to July 23, 1957, National Alfalfa had 47,059 shares of its $50 par value cumulative preferred stock issued and outstanding. The dividend arrearages on each of these shares of preferred stock amounted to $10 as of July 23, 1957.

4. On April 8, 1957 the Board of Directors of National Alfalfa passed a resolution authorizing $2,352,950 in 5% sinking fund debenture bonds to be issued in exchange for National Alfalfa's outstanding preferred stock. Attached hereto and marked Exhibit 11 is a copy of this resolution.

5. If called as witnesses in this case the members of the Board of Directors during 1957 would testify that the principal business purpose behind the 1957 exchange of debentures for the preferred stock was to enable National Alfalfa to expand its eastern producing areas. In order to expand into the eastern areas National Alfalfa's credit requirements for carrying inventory were increased by 50%. To improve National Alfalfa's credit status this transaction also included the issuance of certain warrants to the cumulative preferred share holders which permitted the holder to purchase common stock of National Alfalfa at a stated price in order to eliminate the dividend arrearages owed to them. In addition, the cancellation of the preferred stock and elimination of the dividend arrearages, made it possible for National Alfalfa to declare dividends to the common stockholders thereafter.

6. Attached hereto and marked Exhibit 12 is a copy of the indenture dated July 1, 1957 between National Alfalfa and Fidelity-Philadelphia Trust Company, as trustee.

7. Attached hereto and marked Exhibit 13 is a specimen copy of the debentures containing the terms and conditions thereof.

8. Attached hereto and marked Exhibit 14 is a specimen copy of the warrants containing the terms and conditions thereof.

9. On July 23, 1957 the cumulative preferred stockholders of National Alfalfa exchanged their preferred stock of National Alfalfa for the debenture bonds of National Alfalfa due in 1975. Each unit of the debenture had a fixed maturity value of $50.

10. The preferred stock received by National Alfalfa in exchange for the debenture was retired and cancelled upon the issuance of the bond indebtedness by an entry on National Alfalfa's books debiting preferred stock for $2,352,950 thereby completely eliminating the preferred stock account and crediting the liability account for 18 year 5% debentures for the same amount. Attached hereto and marked Exhibit 15 is a photocopy of the above stated Journal Entry dated August 1, 1957.

11. On behalf of National Alfalfa, Fidelity-Philadelphia Trust Company requested a ruling from the United States Treasury Department. Attached hereto and marked Exhibit 16 is a photocopy of the United States Treasury Department's ruling letter signed by Francis B. Rapp and dated May 29, 1957, in reply to the request for ruling. (Respondent objects to the admission into evidence of the foregoing facts and Exhibit 16 on the grounds of materialty and relevancy.)

12. On its return for its fiscal year ended April 30, 1958 National Alfalfa used the fair market value of $33 per share to determine the disallowed debt discount expense.

13. Attached hereto and marked Exhibit 17 is a copy of a letter from Francis I. Dupont and Company dated August 14, 1959 which accurately reflects the quoted over-the-counter market value of National Alfalfa preferred stock during the period July 15, 1957 through July 30, 1957, inclusive.

14. Attached hereto and marked Exhibit 18 is a copy of the National Stock Summary dated October 1, 1957 relating to actual trades and established prices of the preferred stock of National Alfalfa made in July, 1957.

15. As a result of the exchange in 1957 National Alfalfa claimed a deduction for debt discount attributable to the aggregate amount of the difference between the face value of the debentures ($2,352,950) and the determined fair market value of the preferred stock on the date of the exchange ($1,552,947). The difference of $800,003 was accordingly amortized over the years 1957 through 1975 and appropriate amounts were taken as deductions each year through April 30, 1967.

16. The deduction claimed by National Alfalfa each year for debt discount was computed on the basis of the total of two different variables.

1. The unamortized discount of bonds redeemed or repurchased and retired by National Alfalfa in the year of the deduction, and

2. The annual straight line amortization on those bonds still outstanding at the end of the year.

17. The deduction for discount taken by National Alfalfa on its Federal Income Tax Returns for its fiscal years ended April 30, 1958 through April 30, 1967 are as follows:

Year Ended	Unamortized Discount On Bonds Currently Repurchased or Redeemed	Straight-Line Amortization	Total
4/30/58	–0–	37,037.00	37,037.00
4/30/59	20,104.00	43,273.00	63,377.00
4/30/60	17,007.00	42,310.00	59,317.00
4/30/61	–0–	28,743.00	28,743.00
4/30/62	14,062.00	27,751.00	41,813.00
4/30/63	–0–	27,751.00	27,751.00
4/30/64	26,624.00	25,562.00	52,186.00
4/30/65	37,903.00	22,168.00	60,071.00
4/30/66	4,139.00	21,761.00	25,900.00
4/30/67	98,824.00	10,980.00	109,804.00
			505,999.00

18. As required by the indenture a sinking fund was established in order to secure funds to redeem the debenture bonds. In lieu of making all or any part of the sinking fund payments in cash National Alfalfa is also authorized by the terms of the indenture in Article VI to deliver outstanding debentures to the sinking fund trustee which have either been redeemed or purchased by National Alfalfa on the open market.

19. National Alfalfa has at all times been on schedule following the provisions of the sinking fund and is not now nor at any time pertinent hereto been in default of any of the terms of the indenture. Attached hereto and marked Exhibit 19 is a composite report from the trustee of the sinking fund showing National Alfalfa's compliance

with the provisions of the indenture relating to the sinking fund.

20. As of April 30, 1967, only 11,626 of the original 47,059 debenture bonds of National Alfalfa remained outstanding, as a result of the sinking fund trustee and National Alfalfa having redeemed or otherwise repurchased and retired the other 35,433 debentures.

21. Attached hereto and marked Exhibit 20 is a photocopy of the Notice of Annual Meeting of Stockholders dated June 21, 1957.

22. Attached hereto and marked Exhibit 21 is a specimen copy of the 5% Cumulative Preferred Stock of the par value of $50.00 per share of National Alfalfa which was exchanged share for share for $50.00 Debentures on July 23, 1957.

23. Attached hereto and marked Exhibit 22 is a photocopy of Composite Certificate of Incorporation of National Alfalfa dated May 3, 1946.

/s/ James J. Melching
/s/ Charles W. Hess
Counsel for Petitioner
/s/ K. Martin Worthy,
K. Martin Worthy,
Chief Counsel,
Internal Revenue Service

524-785 O - 73 - 3

STIPULATION EXHIBIT 1–A

Corporation Income Tax Return (Form 1120) for Taxable Year Ending April 30, 1958, and Amended Return for Same Period.

FORM **1120**

U. S. Treasury Department
Internal Revenue Service

U. S. CORPORATION INCOME TAX RETURN

FOR CALENDAR YEAR 1957

or other taxable year beginning May 1, 1957,
and ending April 30, 1958

1957

Do not write in space below

CR 301

PLEASE TYPE OR PRINT PLAINLY

Name
National Alfalfa Dehydrating and Milling Company

Number and street

City or town, postal zone number, county, State
Lamar, Colorado

RECEIVED
INT. REV.
DENVER

A. Date incorporated 5-4-40

B. Place incorporated Delaware

C. Business group code number and principal business activity (See page 8 of Instructions)
419 Mfr. and sales of Alfalfa meal

D. Did the corporation at any time during the taxable year own 50 percent or more of the voting stock of a domestic corporation? ☒ Yes ☐ No
Did any corporation, individual, partnership, trust, or association at any time during the taxable year own 50 percent or more of the corporation's voting stock? ☐ Yes ☒ No
If either answer is "Yes," attach separate schedule showing:
(1) name and address;
(2) percentage of stock owned; Schedule 4
(3) date stock was acquired; and
(4) the District Director's office in which the income tax return of such corporation, individual, partnership, trust, or association for the last taxable year was filed.

E. If corporation is a cooperative association, check whether:
(1) ☐ farmers' marketing or a farmers' purchasing cooperative association,
(2) ☐ consumers' cooperative association, or
(3) ☐ other cooperative association.

F. Check if taxpayer is a sole proprietorship ☐ or partnership ☐ electing under section 1361 to be taxed as a corporation.

G. Did the corporation, during the taxable year, have any contracts or subcontracts subject to the Renegotiation Act of 1951? ☐ Yes ☒ No
If answer is "Yes," state the approximate aggregate gross dollar amount billed during the taxable year under all such contracts and/or subcontracts. (See Instruction G-(4)) $

H. Did the corporation at any time during the taxable year own directly or indirectly any stock of a foreign corporation? ☐ Yes ☒ No
If answer is "Yes," attach statement as required by Instruction K.

I. Enter amount of income (or deficit) from:
(a) line 32, page 3, Form 1120, 1955 $ (775,290.87)
(b) line 32, page 3, Form 1120, 1956 556,381.37

J. Is this a consolidated return of an affiliated group of corporations? (See Instruction I) ☐ Yes ☒ No
If answer is "Yes," Form 1122 must be attached for each subsidiary.

K. Is taxpayer a personal holding company? ☐ Yes ☒ No
If answer is "Yes," Schedule 1120 PH must be attached.

L. Did the corporation make a return of information on Forms 1096 and 1099 for the calendar year 1957 in connection with:
Taxable dividends None ☐ Yes ☐ No
Other payments ☒ Yes ☐ No
(See Instruction G-(1).)

M. Is taxpayer a resident foreign corporation? (See Instruction H) ☐ Yes ☒ No

FILL IN REMAINDER OF THIS PAGE AFTER COMPLETING PAGES 2 AND 3

▶ Enter amounts shown on page 2, if none write "None": line 1, $8,170,932.19 line 4, $ None line 15, $1,542,674.95

COMPUTATION OF TAX DUE OR REFUND

1. Total income tax (line 50, page 3)		$ None
2. Credits for amounts paid on 1957 income tax:		
A. Tax paid with application for extension of time in which to file	$	
B. Payments and credits on 1957 Declaration of Estimated Tax	4,800.00	$ 4,800.00
3. If tax (line 1) is larger than payments (line 2), the balance is **TAX DUE.** Enter such balance here ▶ (For installment payments see Instruction D.)		$
4. If payments (line 2) are larger than tax (line 1) Enter the **OVERPAYMENT** here ▶		$ 4,800.00
5. Enter amount of line 4 you want: Credited on 1958 estimated tax $		
Refunded $ 4,800.00		

SIGNATURE AND VERIFICATION (See Instruction E)

I declare under the penalties of perjury that this return (including any accompanying schedules and statements) has been examined by me and to the best of my knowledge and belief is a true, correct, and complete return.

June 13, 1958 (Date) — (Signature of officer) — Treasurer (Title) — CORPORATE SEAL

I declare under the penalties of perjury that I prepared this return for the taxpayer named herein; and that this return (including any accompanying schedules and statements) is, to the best of my knowledge and belief, a true, correct, and complete return based on all the information relating to the matters required to be reported in this return of which I have any knowledge.

JUN 12 '58 (Date) — Peat, Marwick, Mitchell & Co. (Individual or firm signature) — PEAT, MARWICK, MITCHELL & CO. 817 SEVENTEENTH STREET DENVER 2, COLORADO (Address)

FORM 1120

Form 1120–1957 **TAXABLE INCOME COMPUTATION**

Instruction and Line No.

GROSS INCOME

1. Gross sales (where inventories are an income-determining factor) $ ..... ; Less: Returns and allowances $			$ 8,170,932.19
2. Less: Cost of goods sold (Schedule A) ..... SCHEDULE 2			6,665,706.26
3. Gross profit from sales			$ 1,505,225.93
4. Gross receipts (where inventories are not an income-determining factor)	$		
5. Less: Cost of operations (Schedule B)			
6. Gross profit where inventories are not an income-determining factor			
7. Dividends (Schedule C)			
8. Interest on loans, notes, mortgages, bonds, bank deposits, etc.			618.16

	Gross Amount of Interest	Less: Amortizable Bond Premium	
9. Interest on corporation bonds, etc.	$	$	
10. Interest on obligations of the United States, etc.:			
(a) Issued prior to March 1, 1941—(1) U. S. savings bonds and Treasury bonds owned in excess of the principal amount of $5,000, and (2) obligations of an instrumentality of the U. S.			
(b) Obligations issued on or after March 1, 1941, by the U. S. or any agency or instrumentality thereof.			

11. Rents	
12. Royalties	
13. Gains and losses (from separate Schedule D):	
(a) Net short-term capital gain reduced by any net long-term capital loss	
(b) Net long-term capital gain reduced by any net short-term capital loss SCHEDULE 3	18,727.26
(c) Net gain (or loss) from sale or exchange of property other than capital assets	
14. Other income (itemize):	18,103.60
15. Total income in lines 3, and 6 to 14, inclusive	$ 1,542,674.95

DEDUCTIONS

15. Compensation of officers (Schedule E) ..... SCHEDULE 4	$ 123,891.63
17. Salaries and wages (not deducted elsewhere)	163,458.09
18. Rents	125,675.04
19. Repairs (Do not include cost of improvements or capital expenditures)	481,785.12
20. Bad debts (Schedule F) ..... SCHEDULE 4	5,842.79
21. Interest	215,255.94
22. Taxes (Schedule G) ..... SCHEDULE 4	124,425.70
23. Contributions or gifts paid (Schedule H) ..... SCHEDULE 6	
24. Losses by fire, storm, shipwreck, or other casualty, or theft (Attach schedule)	

16—72664-1

25. Amortization (Schedule I)		
26. Depreciation (Schedule I) Sch. 2 & 4	354068.16	
27. Depletion of mines, oil and gas wells, timber, etc. (Attach schedule)		
28. Advertising (Attach schedule)	51498.18	
29. Amounts contributed under:		
(a) Pension, annuity, stock bonus, or profit-sharing plans (Attach schedule)		
(b) Other employee benefit plans (Attach schedule)		
30. Other deductions (Schedule K) SCHEDULE 6	324288.04	
31. Total deductions in lines 16 to 30, inclusive		2070188.69
32. Taxable income before net operating loss deduction and special deductions (Loss)		$ (527513.74)
33. Less: Net operating loss deduction (Attach schedule)		
34. Taxable income before special deductions (Loss)		$ (527,513.74)

SPECIAL DEDUCTIONS

35. Deduction for partially tax-exempt interest (net amount entered on line 10 (a))	$	
36. Dividends-received deductions:		
(a) 85% of column 2, Schedule C	$	
(b) 62.115% of column 3, Schedule C		
(c) 85% of dividends received from certain foreign corporations		
37. Total dividends-received deductions (sum of lines 36 (a), (b), and (c) but not to exceed 85 percent of the excess of line 32 over the sum of lines 35 and 39) (See instructions in case of net operating loss)		
38. Deduction for dividends paid on certain preferred stock of public utilities (See instructions in case of net operating loss)		
39. Deduction for Western Hemisphere trade corporations (See instructions in case of net operating loss)		
40. Total special deductions		$
41. Line 34 less line 40 (Enter income or loss here and on line 42(b)) (Loss)		$ (527,513.74)

TAX COMPUTATION FOR CALENDAR YEAR 1957 AND TAXABLE YEARS ENDING ON OR BEFORE JUNE 30, 1958
For other taxable years attach Schedule 1120 FY (See tax computation instructions)

42. (a) Amount of line 35, $ ... (b) plus amount of line 41, $ ... Enter total here →		$ Loss
43. If amount of line 42 is:		
(a) **Not over $25,000—** Enter 30 percent of line 42 (32 percent if a consolidated return)		$
(b) **Over $25,000—** Enter 52 percent of line 42 (54 percent if a consolidated return)	$	
Subtract $5,500, and enter difference	5,500.00	$
44. Adjustment for partially tax-exempt interest. Enter 30 percent of line 35, but not in excess of 30 percent of line 42		$ NONE
45. Normal tax and surtax (line 43 less line 44)		
46. Income tax (line 45, or line 20 of separate Schedule D)	$	
47. Credit allowed a domestic corporation for income taxes paid to a foreign country or United States possession (submit Form 1118)		
48. Balance of income tax (line 46 less line 47)		$
49. Tax under section 541 of the Internal Revenue Code (from Schedule 1120 PH)		$ NONE
50. Total income tax (line 48 plus line 49). **Enter here and on line 1, page 1**		

16—7.4664-1

ASSETS	Beginning of Taxable Year Amount	Beginning of Taxable Year Total	End of Taxable Year Amount	End of Taxable Year Total
1. Cash		$		$
2. Notes and accounts receivable	$		$	
(a) Less: Reserve for bad debts				
3. Inventories: (a) Other than last-in, first-out				
(b) Last-in, first-out				
4. Prepaid expenses and supplies				
5. Investments in governmental obligations: (a) Obligations of a State, Territory, or a possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia		SCHEDULE 1		
(b) Obligations of the United States and its instrumentalities				
6. Mortgage and real estate loans				
7. Other investments (Attach schedule)				
8. Buildings and other fixed depreciable assets				
(a) Less: Accumulated amortization and depreciation				
9. Depletable assets				
(a) Less: Accumulated depletion				
10. Land (net of any amortization)				
11. Intangible assets (amortizable only)				
(a) Less. Accumulated amortization				
12. Other assets (Attach schedule)				
13. Total Assets				
LIABILITIES AND CAPITAL				
14. Accounts payable				
15. Deposits and withdrawable shares				
16. Bonds, notes, and mortgages payable (maturing less than one year from date of balance sheet)				
17. Accrued expenses (Attach schedule)				
18. Bonds, notes, and mortgages payable (maturing one year or more from date of balance sheet)				
19. Other liabilities (Attach schedule)				
20. Capital stock: (a) Preferred stock				
(b) Common stock				
21. Paid-in or capital surplus				
22. Surplus reserves (Attach schedule)				
23. Earned surplus and undivided profits				
24. Total Liabilities and Capital		$		$

Schedule M.—RECONCILIATION OF TAXABLE INCOME AND ANALYSIS OF EARNED SURPLUS AND UNDIVIDED PROFITS

1. Earned surplus and undivided profits at end of preceding taxable year (Schedule L)	$ 95637.91	9. Total distributions to stockholders charged to earned surplus during the taxable year: (a) Cash	$
2. Taxable income before net operating loss deduction and special deductions (line 32, page 3) (1954)	(127,513.74)	(b) Stock of the corporation	
3. Nontaxable Interest on: (a) Obligations of a State, Territory, or a possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia		(c) Other property	
(b) Obligations of the United States issued on or before Sept. 1, 1917; all postal savings bonds		10. Contributions in excess of 5% limitation	442.00
4. Other nontaxable income (Attach schedule)		11. Federal income and excess profits taxes 1954	243.91
5. Charges against surplus reserves deducted from income in this return (Attach schedule)		12. Income taxes of foreign countries or United States possessions if claimed as a credit in whole or in part on line 47, page 3	
6. Adjustments for tax purposes not recorded on books (Attach schedule)		13. Insurance premiums paid on the life of any officer or employee where the corporation is directly or indirectly a beneficiary	3421.25
7. Sundry credits to earned surplus (Attach schedule) SEE SCHEDULE	204 117.55	14. Unallowable interest incurred to purchase or carry tax-exempt interest obligations	
8. Total of lines 1 to 7	$ 227,767.28	15. Excess of capital losses over capital gains	
		16. Additions to surplus reserves (Attach schedule)	
		17. Other unallowable deductions (Attach schedule)	
		18. Adjustments for tax purposes not recorded on books (Attach schedule)	
		19. Sundry debits to earned surplus (Attach schedule)	
		20. Total of lines 9 to 19	$ 4107.16
		21. Earned surplus and undivided profits (DEFICIT) year (Schedule L) (Line 8 less line 20)	(231,874.44)

Total of the taxable of Schedule M)

NAME National Alfalfa Dehydrating and Milling Co.

CALENDAR YEAR 195__

ADDRESS Lamar, Colorado

FISCAL YEAR ENDING April 30 1958

CORPORATION BALANCE SHEETS

ASSETS	BEGINNING OF TAXABLE YEAR AMOUNT	BEGINNING OF TAXABLE YEAR TOTAL	END OF TAXABLE YEAR AMOUNT	END OF TAXABLE YEAR TOTAL
CASH		587 898 01		126 546 34
NOTES AND ACCOUNTS RECEIVABLE				
LESS: RESERVE FOR BAD DEBTS		236 511 30		602 627 54
INVENTORIES:				
OTHER THAN LAST-IN, FIRST OUT				
LAST-IN, FIRST OUT		455 106 46		924 823 76
PREPAID EXPENSES AND SUPPLIES		367 499 99		476 724 22
INVESTMENTS IN GOVERNMENT OBLIGATIONS: OBLIGATIONS OF A STATE, TERRITORY, OR A POSSESSION OF THE UNITED STATES, OR ANY POLITICAL SUBDIVISION OF ANY OF THE FOREGOING, OR OF THE DISTRICT OF COLUMBIA				
OBLIGATIONS OF THE UNITED STATES AND ITS INSTRUMENTALITIES				
OTHER INVESTMENTS (DETAIL):			112 500 00	
		122 500 00	540 786 46	653 286 46
BUILDINGS AND OTHER FIXED DEPRECIABLE ASSETS	9790 672 93		9526 598 55	
LESS: ACCUMULATED AMORTIZATION AND DEPRECIATION	4627 655 64	763 617 29	3341 581 16	6008 476 39
DEPLETABLE ASSETS				
LESS: ACCUMULATED DEPLETION				
LAND (NET OF ANY AMORTIZATION)		86 446 86		81 446 86
INTANGIBLE ASSETS (AMORTIZABLE ONLY)				
LESS: ACCUMULATED AMORTIZATION				
OTHER ASSETS (DETAIL):				
DEFERRED CHARGES PATENTS	39 897 70		34 795 00	
REFUNDABLE INCOME TAXES			172 189 38	
DEFERRED CHARGES- [illegible]		39 897 70	38 857 10	245 841 48
TOTAL ASSETS		7 659 477 59		9 122 775 10
LIABILITIES AND CAPITAL				
ACCOUNTS PAYABLE		143 129 31		307 100 99
BONDS, NOTES AND MORTGAGES PAYABLE (MATURING LESS THAN ONE YEAR FROM DATE OF BALANCE SHEET)				784 374 54
ACCRUED EXPENSES (DETAIL):				
		164 402 76		156 961 92
BONDS, NOTES AND MORTGAGES PAYABLE (MATURING MORE THAN ONE YEAR FROM DATE OF BALANCE SHEET)		625 000 00		3 495 749 99
OTHER LIABILITIES (DETAIL):				
FEDERAL INCOME TAXES	170 000 00			
DUE TO SUBSIDIARY			4143 000 49	
		170 000 00		44 000 49
CAPITAL STOCK: PREFERRED STOCK	2 352 950 00			
COMMON STOCK	796 000 00	3 142 950 00	2 370 000 00	2 370 000 00
PAID-IN OR CAPITAL SURPLUS	3 378 361 61	3 378 361 61		1 798 361 61
SURPLUS RESERVES (DETAIL):				
EARNED SURPLUS AND UNDIVIDED PROFITS (DEFICIT)		95 633 51		(231 874 44)
TOTAL LIABILITIES AND CAPITAL		7 659 477 59		9 122 775 10

FORM 203M N.A.S.C.O

SCHEDULE 1

NATIONAL ALFALFA DEHYDRATING AND MILLING CO.
INCOME TAX RETURN
YEAR ENDED APRIL 30 1958

Cost of Goods Sold

Hay used			
Beginning inventory			$ 7702.00
Purchases			1981105.04
Harvesting expenses			264895.11
			2253702.15
Forwarding inventory			114473.47
			2242228.68
Bags used:			
Beginning inventory		$ 113485.20	
Purchases		305513.87	
		418999.07	
Ending inventory		85466.68	333532.19
Production costs - direct and indirect			
Salaries		525564.38	
Labor		1522495.55	
Fuel and power		1059011.52	
Auto allowance		46793.89	
Other costs		588941	
Oil for meal		114131.14	
Insurance		204381.01	
Warehouse costs		190178.79	
Laboratory		7851.67	
		24497.38	
Storage gas		16645.60	
Amortization of patents		5102.70	
Trucking meal to blenders		3228010	3809825.14
Finished product:			
Beginning inventory		315142.28	
Purchases		773035.54	
		1088177.82	
Ending inventory		808057.57	280120.25
			$ 6665706.26

SCHEDULE 2

NAME NATIONAL ALFALFA DEHYDRATING & MILLING CO

ADDRESS LAMAR, COLORADO

CALENDAR YEAR ENDED 4-30-58

SCHEDULE OF CAPITAL GAINS AND LOSSES

KIND OF PROPERTY	ACQUIRED	SOLD	SALES PRICE	COST	EXPENSE	DEPRECIATION	GAIN OR (LOSS) TAKEN INTO ACCOUNT FEDERAL LONG TERM	FEDERAL SHORT TERM	%	STATE
Land	varies		5500 00	5000 00			500 00			
Buildings	"		55865 22	108582 17		38921 27	(13795 66)			
Machinery & equipment	"		56656 62	240775 11		208719 04	24608 49	(894)		
Trucks	"		11343 11	110164 32		105817 96	13497 50	1499 35		
Autos	"		5481 28	19116 74		16851 58	3178 62	37 50		
Furniture & fixture	"		550 00	1007 68		808 95	351 07			
Harvesting equipment	"		7525 00	33416 81		27384 31	742 50	750 00		
Laboratory equipment	"		315 00	400 00		130 00	45 00			
Residences & labor houses	"		8855 00	26665 01		10506 74	(7328 21)			
			160086 23	554794 93		403,138 90	21799 20	2277 91		
100 shs. Nalley Hardware Co	1956	10-21-57	1650 06	10 000 00			(5349 94)			
			164736 29	555167 93			16449 26	2277 91		
							2277 91			
							15 727 26			
TOTAL										

FORM 55

SCHEDULE 3

NATIONAL ALFALFA DEHYDRATING AND MILLING CO.
INCOME TAX RETURN
YEAR ENDED APRIL 30, 1958

Compensation of officers

Name and address		Title	Time devoted to business	Compensation
N. A. Hofmann	Sterling Springs, Pa.	President	Part	$ 25654.71
W. P. West	Lamar, Colorado	Vice Pres.	All	13221.61
J. A. Bunch	"	" "	All	12544.81
A. R. McFadden	Kansas City, Mo.	" "	All	22140.00
Grace Estep	Lamar, Colorado	" "	All	11888.51
L. R. Pollack	"	Secretary	All	10767.97
F. N. Reed	"	Treasurer	All	9314.40
W. B. Shackelford	"	Comptroller	All	9314.40
Stanley Cox	"	Asst. V. Pres.	All	9045.22
				$ 123,891.63

Bad debts

Year ended April 30	Net sales	Bad debts written off
1954	$ 7975 633 28	1023.71
1955	9666 615.02	1942.79
1956	7571 373.16	1648.31
1957	8857 524.11	(26.79)
1958	8170 932.19	5842.79

Taxes

Property taxes	$ 91285.27
Payroll taxes	106545.88
Auto and truck licenses	21693.20
Corporation franchise and miscellaneous	4837.04
	224,361.39
State income taxes	64.31
	$ 224425.70

Question 2 - Page 1 (federal return) - 50% or more of voting stock of another domestic corporation owned by National Alfalfa Dehydrating & Milling Co:

(1) Midland Industries, Inc.
(2) 99.825 %
(3) 12-1-57
(4) Denver, Colorado

SCHEDULE 4

NATIONAL ALFALFA DEHYDRATING AND MILLING CO.
INCOME TAX RETURN
YEAR ENDED APRIL 30, 1958

Fixed assets and reserves for depreciation

	Balances beginning of year	Additions	Retirements	Balance - End of year
Property accounts				
Buildings	$ 2991522.98	137853.26	135347.17	2994029.07
Machinery	4776827.22	696714.75	276215.21	5197326.76
Harvesting equipment	998969.58	109660.72	44596.81	1063033.49
Miscellaneous equipment	64790.41	175314	4000	66143.55
Autos and trucks	492051.95	43519.83	12928.96	522642.82
Furniture and fixtures	82263.96	2924.71	1007.88	84180.79
Construction in progress	384246.83	(249191.76)	-	135055.07
	$ 9790672.93	743234.65	583848.03	9950059.55
Reserves for depreciation				
Buildings	$ 664957.67	77148.82	49495.86	692610.63
Machinery	2110470.25	149688.12	23179.93	2028407.44
Harvesting equipment	763334.47	59223.89	35564.31	786994.05
Miscellaneous	41622.58	4031.40	9800	45554.98
Autos and trucks	398071.36	58964.28	122669.54	334366.10
Furniture and fixtures	48599.31	5011.65	-	53610.96
	$ 4027055.64	354068.16	439542.64	3941581.16

SCHEDULE V

NATIONAL ALFALFA DEHYDRATING AND MILLING CO.
INCOME TAX RETURN
YEAR ENDED APRIL 30, 1958

Contributions

Community chest and United Funds	$ 240.00
Boy Scouts of America	75.00
Girl Scouts of America	10.00
Red Cross	15.00
Salvation Army	50.00
Christmas seals	5.00
Other	47.00
Contributions available for carryover to 1959	$ 442.00

Other deductions

Supplies	$ 22492.96
Travel	7,835.98
Telephone and telegraph	8548.19
Postage	709.84
Dues and subscriptions	1992.20
Stock offices	11579.48
Insurance	9721.8
Legal	6135.94
Audit	6449.85
Warehousing costs	20830.48
Commissions and brokerage	67744.20
Collection offices	10217.70
Registration	914.50
Inspection fees	7782.93
Loss on equipment retired	1581.61
	$ 324288.04

Surplus credits

Accrual of refundable federal income tax under loss carry-back provision 1957	$ 167389.38
Overaccrual of income taxes 1957	36723.17
	$ 204112.55

SCHEDULE 6

AMENDED

FORM **1120**
U. S. Treasury Department
Internal Revenue Service

U. S. CORPORATION INCOME TAX RETURN

FOR CALENDAR YEAR 1957

or other taxable year beginning May 1, 1957,
and ending April 30, 1958

1957

Do not write in space below

RECEIVED
SEP 14 1959
DIR. INT. REV.
84 DENVER

PLEASE TYPE OR PRINT PLAINLY

Name
National Alfalfa Dehydrating and Milling Company

Number and street

City or town, postal zone number, county, State
Lamar, Colorado

A. Date incorporated May 4, 1946

B. Place incorporated Delaware

C. Business group code number and principal business activity (See page 8 of Instructions)
419 - Manufacture and sale of alfalfa meal

D. Did the corporation at any time during the taxable year own 50 percent or more of the voting stock of a domestic corporation? ☒ Yes ☐ No
Did any corporation, individual, partnership, trust, or association at any time during the taxable year own 50 percent or more of the corporation's voting stock? ☐ Yes ☒ No
If either answer is "Yes," attach separate schedule showing:
(1) name and address;
(2) percentage of stock owned;
(3) date stock was acquired; and
(4) the District Director's office in which the income tax return of such corporation, individual, partnership, trust, or association for the last taxable year was filed.
Supplied with original return

E. If corporation is a cooperative association, check whether:
(1) ☐ farmers' marketing or a farmers' purchasing cooperative association,
(2) ☐ consumers' cooperative association, or
(3) ☐ other cooperative association.

F. Check if taxpayer is a sole proprietorship ☐ or partnership ☐ electing under section 1361 to be taxed as a corporation.

G. Did the corporation, during the taxable year, have any contracts or subcontracts subject to the Renegotiation Act of 1951? ☐ Yes ☒ No
If answer is "Yes," state the approximate aggregate gross dollar amount billed during the taxable year under all such contracts and/or subcontracts. (See Instruction G-(4)) $

H. Did the corporation at any time during the taxable year own directly or indirectly any stock of a foreign corporation? ☐ Yes ☒ No
If answer is "Yes," attach statement as required by Instruction K.

I. Enter amount of income (or deficit) from:
(a) line 32, page 3, Form 1120, 1955 $ (860,856.87)*
(b) line 32, page 3, Form 1120, 1956 $ 517,206.37 *

J. Is this a consolidated return of an affiliated group of corporations? (See Instruction D) ☐ Yes ☒ No
If answer is "Yes," Form 1122 must be attached for each subsidiary.

K. Is taxpayer a personal holding company? ☐ Yes ☒ No
If answer is "Yes," Schedule 1120 PH must be attached.

L. Did the corporation make a return of information - Forms 1096 and 1099 for the calendar year 1957 in connection with:
Taxable dividends None ☐ Yes ☒ No
Other payments ☒ Yes ☐ No
(See Instruction G-(1).)

M. Is taxpayer a resident foreign corporation? (See Instruction H) ☐ Yes ☒ No

*As amended

FILL IN REMAINDER OF THIS PAGE AFTER COMPLETING PAGES 2 AND 3

▶ Enter amounts shown on page 2, if none write "None": line 1, $ 8,170,932.19 line 4, $ None line 15, $ 1,542,674.95

COMPUTATION OF TAX DUE OR REFUND

1. Total income tax (line 50, page 3)		$ None
2. Credits for amounts paid on 1957 income tax:		
A. Tax paid with application for extension of time in which to file	$	
B. Payments and credits on 1957 Declaration of Estimated Tax		$
3. If tax (line 1) is larger than payments (line 2), the balance is **TAX DUE.** Enter such balance here ▶ (For installment payments see Instruction D.)		$ None
4. If payments (line 2) are larger than tax (line 1) Enter the **OVERPAYMENT** here ▶		$
5. Enter amount of line 4 you want: Credited on 1958 estimated tax $		
Refunded $		

SIGNATURE AND VERIFICATION (See Instruction E)

I declare under the penalties of perjury that this return (including any accompanying schedules and statements) has been examined by me and to the best of my knowledge and belief is a true, correct, and complete return.

9-11-59 (Date) [signature] (Signature of officer) [signature] (Title)

CORPORATE SEAL

I declare under the penalties of perjury that I prepared this return for the taxpayer named herein; and that this return (including any accompanying schedules and statements) is, to the best of my knowledge and belief, a true, correct, and complete return based on all the information relating to the matters required to be reported in this return of which I have any knowledge.

(Date) Statement attached. (Individual or firm signature) (Address)

815
Card
Date 10-1-59

FORM 1120

Instruction and Line No.	GROSS INCOME			
1.	Gross sales (where inventories are an income-determining factor) $; Less: Returns and allowances $		$ 8,170,932.19	
2.	Less: Cost of goods sold (Schedule A)		6,665,706.26	*
3.	Gross profit from sales		$ 1,505,225.93	
4.	Gross receipts (where inventories are not an income-determining factor)	$		
5.	Less: Cost of operations (Schedule B)			
6.	Gross profit where inventories are not an income-determining factor			
7.	Dividends (Schedule C)			
8.	Interest on loans, notes, mortgages, bonds, bank deposits, etc.		618.16	
		Gross Amount of Interest	Less: Amortizable Bond Premium	
9.	Interest on corporation bonds, etc.	$	$	
10.	Interest on obligations of the United States, etc.:			
	(a) Issued prior to March 1, 1941—(1) U. S. savings bonds and Treasury bonds owned in excess of the principal amount of $5,000, and (2) obligations of an instrumentality of the U. S.			
	(b) Obligations issued on or after March 1, 1941, by the U. S. or any agency or instrumentality thereof			
11.	Rents			
12.	Royalties			
13.	Gains and losses (from separate Schedule D):			
	(a) Net short-term capital gain reduced by any net long-term capital loss			
	(b) Net long-term capital gain reduced by any net short-term capital loss		18,727.26	*
	(c) Net gain (or loss) from sale or exchange of property other than capital assets			
14.	Other income (itemize): Miscellaneous		18,103.60	
15.	Total income in lines 3, and 6 to 14, inclusive			$ 1,542,674.95
	DEDUCTIONS			
16.	Compensation of officers (Schedule E)		$ 123,891.63	*
17.	Salaries and wages (not deducted elsewhere)		163,458.09	
18.	Rents		125,675.04	
19.	Repairs (Do not include cost of improvements or capital expenditures)		481,785.12	
20.	Bad debts (Schedule F)		5,842.79	*
21.	Interest		215,255.94	
22.	Taxes (Schedule G)		224,425.70	*
23.	Contributions or gifts paid (Schedule H)			
24.	Losses by fire, storm, shipwreck, or other casualty, or theft (Attach schedule)			

25. Amortization (Schedule I)		
26. Depreciation (Schedule J)	523,826.45	
27. Depletion of mines, oil and gas wells, timber, etc. (Attach schedule)		
28. Advertising (Attach schedule)	51,498.18	*
29. Amounts contributed under:		
(a) Pension, annuity, stock bonus, or profit-sharing plans (Attach schedule)		
(b) Other employee benefit plans (Attach schedule)		
30. Other deductions (Schedule K)	363,067.04	
31. Total deductions in lines 16 to 30, inclusive		2,278,725.98
32. Taxable income before net operating loss deduction and special deductions	Loss	$ (736,051.03)
33. Less: Net operating loss deduction (Attach schedule)		
34. Taxable income before special deductions		$ (736,051.03)

SPECIAL DEDUCTIONS

35. Deduction for partially tax-exempt interest (net amount entered on line 10 (a))	$	
36. Dividends-received deductions:		
(a) 85% of column 2, Schedule C	$	
(b) 62.115% of column 3, Schedule C		
(c) 85% of dividends received from certain foreign corporations		
37. Total dividends-received deductions (sum of lines 36 (a), (b), and (c) but not to exceed 85 percent of the excess of line 32 over the sum of lines 35 and 39) (See instructions in case of net operating loss)		
38. Deduction for dividends paid on certain preferred stock of public utilities (See instructions in case of net operating loss)		
39. Deduction for Western Hemisphere trade corporations (See instructions in case of net operating loss)		
40. Total special deductions		$
41. Line 34 less line 40 (Enter income or loss here and on line 42(b))	Loss	$ (736,051.03)

*Supporting schedules filed with original return and are not amended.

TAX COMPUTATION FOR CALENDAR YEAR 1957 AND TAXABLE YEARS ENDING ON OR BEFORE JUNE 30, 1958
For other taxable years attach Schedule 1120 FY (See tax computation instructions)

42. (a) Amount of line 35, $ ____ (b) plus amount of line 41, $ Loss (736,051.03) Enter total here →		$ (736,051.03)
43. If amount of line 42 is:		
(a) Not over $25,000—		
Enter 30 percent of line 42 (32 percent if a consolidated return)		$
(b) Over $25,000—		
Enter 52 percent of line 42 (54 percent if a consolidated return)	$	
Subtract $5,500, and enter difference	5,500.00	$
44. Adjustment for partially tax-exempt interest. Enter 30 percent of line 35, but not in excess of 30 percent of line 42		
45. Normal tax and surtax (line 43 less line 44)		$ None
46. Income tax (line 45, or line 20 of separate Schedule D)	$	
47. Credit allowed a domestic corporation for income taxes paid to a foreign country or United States possession (submit Form 1118)		
48. Balance of income tax (line 46 less line 47)		$
49. Tax under section 541 of the Internal Revenue Code (from Schedule 1120 PH)		
50. Total income tax (line 48 plus line 49). Enter here and on line 1, page 1		$ None

Schedule L.—BALANCE SHEETS (See Instructions)

ASSETS	Beginning of Taxable Year		End of Taxable Year	
	Amount	Total	Amount	Total
1. Cash		$		$
2. Notes and accounts receivable	$		$	
(a) Less: Reserve for bad debts				
3. Inventories: (a) Other than last-in, first-out				
(b) Last-in, first-out				
4. Prepaid expenses and supplies				
5. Investments in governmental obligations: (a) Obligations of a State, Territory, or a possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia		Schedule supplied with original return.		
(b) Obligations of the United States and its instrumentalities				
6. Mortgage and real estate loans				
7. Other investments (Attach schedule)				
8. Buildings and other fixed depreciable assets				
(a) Less: Accumulated amortization and depreciation				
9. Depletable assets				
(a) Less: Accumulated depletion				
10. Land (net of any amortization)				
11. Intangible assets (amortizable only)				
(a) Less: Accumulated amortization				
12. Other assets (Attach schedule)				
13. Total Assets				
LIABILITIES AND CAPITAL				
14. Accounts payable				
15. Deposits and withdrawable shares				
16. Bonds, notes, and mortgages payable (maturing less than one year from date of balance sheet)				
17. Accrued expenses (Attach schedule)				
18. Bonds, notes, and mortgages payable (maturing one year or more from date of balance sheet)				
19. Other liabilities (Attach schedule)				
20. Capital stock: (a) Preferred stock				
(b) Common stock				
21. Paid-in or capital surplus				
22. Surplus reserves (Attach schedule)				
23. Earned surplus and undivided profits				
24. Total Liabilities and Capital		$		$

Schedule M.—RECONCILIATION OF TAXABLE INCOME AND ANALYSIS OF EARNED SURPLUS AND UNDIVIDED PROFITS

1. Earned surplus and undivided profits at end of preceding taxable year (Schedule L)	$	9. Total distributions to stockholders charged to earned surplus during the taxable year: (a) Cash	$
2. Taxable income before net operating loss deduction and special deductions (line 32, page 3)		(b) Stock of the corporation	
3. Nontaxable interest on: (a) Obligations of a State, Territory, or a possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia		(c) Other property	Schedule
(b) Obligations of the United States issued on or before Sept. 1, 1917; all postal savings bonds		10. Contributions in excess of 5% limitation	
4. Other nontaxable income (Attach schedule)		11. Federal income and excess profits taxes	attached
5. Charges against surplus reserves deducted from income in this return (Attach schedule)		12. Income taxes of foreign countries or United States possessions if claimed as a credit in whole or in part on line 47, page 3	
6. Adjustments for tax purposes not recorded on books (Attach schedule)		13. Insurance premiums paid on the life of any officer or employee where the corporation is directly or indirectly a beneficiary	
7. Sundry credits to earned surplus (Attach schedule)		14. Unallowable interest incurred to purchase or carry tax-exempt interest obligations	
8. Total of lines 1 to 7	$	15. Excess of capital losses over capital gains	
		16. Additions to surplus reserves (Attach schedule)	
		17. Other unallowable deductions (Attach schedule)	
		18. Adjustments for tax purposes not recorded on books (Attach schedule)	
		19. Sundry debits to earned surplus (Attach schedule)	
		20. Total of lines 9 to 19	$
		21. Earned surplus and undivided profits at end of the taxable year (Schedule L) (Line 8 less line 20 of Schedule M)	$

The information required in Schedules A through K on pages 5 and 6 may be furnished on separate attachments provided that the attachments conform to the format of the printed schedules and the necessary figures are carried forward to the appropriate lines on pages 2 and 3. Where acceptable attachments are used, detach and discard pages 5 and 6.

Name and Address (Number, street, city, postal zone, county, State)

National Alfalfa Dehydrating and Milling Company
Lamar, Colorado

Schedule A.—COST OF GOODS SOLD. (See Instruction 2)
(Where inventories are an income-determining factor)

1. Inventory at beginning of year	$	
2. Merchandise bought for manufacture or sale		
3. Salaries and wages		
4. Other costs per books (Attach schedule)		
5. Total	$	
6. Less: Inventory at end of year		
7. Cost of goods sold (Enter here and on line 2, page 2)	$	

Schedule B.—COST OF OPERATIONS
(Where inventories are not an income-determining factor)

1. Salaries and wages	$	
2. Other costs (to be detailed):		
(a)		
(b)		
(c)		
(d)		
(e)		
3. Total (Enter here and on line 5, page 2)	$	

Schedule C.—INCOME FROM DIVIDENDS

1. Name of Declaring Corporation	2. Domestic Corporations Taxable Under Chapter 1, Internal Revenue Code*	3. Certain Preferred Stock of Public Utilities Taxable Under Chapter 1, Internal Revenue Code	4. Foreign Corporations	5. Other Corporations
	$	$	$	$
Totals	$	$	$	$
Total of columns 2, 3, 4, and 5 (Enter here and on line 7, page 2)				$

*Except (a) dividends on certain preferred stock of public utilities, which should be entered in column 3; and (b) dividends, which should be entered in column 5, received from China Trade Act corporations, from corporations to which section 931 applies, and from corporations exempt from tax under sections 501 and 521.

Schedule D.—Separate Schedule D (Form 1120) should be used in reporting sales or exchanges of property and filed with this return (See Instruction 13)

Schedule E.—COMPENSATION OF OFFICERS

1. Name and Address of Officer	2. Official Title	3. Time Devoted to Business	Percentage of Corporation's Stock Owned		6. Amount of Compensation
			4. Common	5. Preferred	
					$
Total compensation of officers (Enter here and on line 16, page 2)					$

Schedule F.—BAD DEBTS. (See Instruction 20)

1. Taxable Year	Amount of Notes and Accounts Receivable Outstanding at—		4. Taxable (or Net) Income Reported	5. Sales on Account	6. Bad Debts of Corporation if No Reserve is Carried on Books	If Corporation Carries a Reserve	
	2. Beginning of Year	3. End of Year				7. Gross Amount Added to Reserve	8. Amount Charged Against Reserve
1954							
1955							
1956							
1957							

NOTE. Securities which are capital assets and which became worthless within the taxable year should be reported in separate Schedule D.

Schedule G.—TAXES. (See Instruction 22)

Explanation	Amount
	$
Total (Enter here and on line 22, page 2)	$

Schedule H.—CONTRIBUTIONS OR GIFTS PAID (See Instruction 23)

Name and Address of Organization	Amount
	$
Contributions carryover (See instructions)	
Total contributions (Enter here and on line 23, page 2, subject to 5 percent limitation)	$

Schedule I.—AMORTIZATION. (See Instruction 25)

1. Describe Facilities or Expenditures Being Amortized	2. Date Acquired, Completed, or Expended	3. Amount Being Amortized	4. Amortization Deducted in Prior Years	5. Amortization Period (Number of months)	6. Amortization This Year
		$	$		$

1. Total ..... $
2. Less: Amount of amortization claimed in Schedules A and B and elsewhere on return .....
3. Balance—Enter here and on line 25, page 3 ..... $

Schedule J.—DEPRECIATION. (See Instruction 26)

1. Kind of Property (if buildings, state material of which constructed). Exclude Land and Other Nondepreciable Property. List Assets in Groups by Depreciation Method	2. Date Acquired	3. Cost or Other Basis	4. Depreciation Allowed (or allowable) in Prior Years	5. Method of Computing Depreciation	6. Rate (%) or Life (years)	7. Depreciation This Year
		$	$			$
	Schedule attached					

1. Total ..... $
2. Less: Amount of depreciation claimed in Schedules A and B and elsewhere on return .....
3. Balance—Enter here and on line 26, page 3 ..... $

SUMMARY OF SCHEDULES I AND J

Part A.—DEPRECIATION		Part B.—AMORTIZATION	
1. Straight line method	$ 523,826.45	7. Emergency facilities	$
2. Declining balance method		8. Grain storage facilities	
3. Sum of the years-digits method		9. Research or experimental expenditures	
4. Based on units of production		10. Exploration and development expenditures	
5. Other methods		11. Organizational expenditures	
		12. Trademark and trade name expenditures	
6. Total depreciation claimed	$ 523,826.45	13. Total amortization claimed	$

Schedule K.—OTHER DEDUCTIONS. (See Instruction 30)

	$		$
	Schedule attached		
		Total (Enter here and on line 30, page 3)	$

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY
Lamar, Colorado

Amended U. S. Corporation Income Tax Return
Year Ended April 30, 1958

LIST OF ATTACHMENTS

Statement re preparation of return

Schedule	
J	Depreciation
J-1	Statement re change in depreciation rates
K	Other deductions
K-1	Statement re amortization of discount on debentures issued
K-2	Statement re loss on disposition of Pecos Valley and Denver Alfalfa assets
M	Reconciliation of taxable income and analysis of changes in surplus
Y	Disposition of net operating loss deductions of prior years

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY
Lamar, Colorado
U. S. Corporation Income Tax Return
Amended Return
Year Ended April 30, 1958

I, Stewart S. Finkler, acting on behalf
Price Waterhouse & Co., Philadelphia, Pennsylvania, declare und
the penalty of perjury that I prepared the attached amended U.
corporation income tax return of National Alfalfa Dehydrating a
Milling Company covering the fiscal year ended April 30, 1958 w
shows a loss of $736,051.03, on the basis of information furnis
by the taxpayer; that the information set out in the amended re
and accompanying schedules correctly and fairly reflects inform
furnished to me during the course of the preparation of the ret
that said information is true to the best of my information and
belief.

Stewart S. Finkler

Schedule J

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY
Lamar, Colorado

Amended Return

Year Ended April 30, 1958

FIXED ASSETS AND RESERVES FOR DEPRECIATION

Property	Acquired	Balance - beginning of year	Additions	Retirements	Balance - end of year
Buildings	Various	$2,991,522.98	$137,853.26	$135,347.17	$2,994,029.07
Machinery	"	4,776,827.22	696,714.75	276,215.21	5,197,326.76
Harvesting equipment	"	998,969.58	103,660.72	41,596.81	1,067,033.49
Miscellaneous equipment	"	64,790.41	1,753.14	400.00	66,143.55
Autos and trucks	"	492,051.95	43,519.83	129,280.96	406,290.82
Furniture and fixtures	"	82,263.96	2,924.71	1,007.88	84,180.79
Construction in progress	"	384,246.83	(249,191.76)		135,055.07
		$9,790,672.93	$743,234.65	$583,848.03	$9,950,059.55
Reserves for depreciation					
Buildings		$ 664,957.67	$104,190.84	$ 49,459.86	$ 719,688.65
Machinery		2,110,470.25	292,404.39	231,750.93	2,171,123.71
Harvesting equipment		763,334.47	59,223.89	35,564.31	786,994.05
Miscellaneous equipment		41,622.58	4,031.40	98.00	45,555.98
Autos and trucks		398,071.36	58,964.28	122,669.54	334,366.10
Furniture and fixtures		48,599.31	5,011.65		53,610.96
		$4,027,055.64	$523,826.45*	$439,542.64	$4,111,339.45

*See statement attached re amendment of depreciation rates.

Schedule J-1

NATIONAL ALFALFA DEHYDRATING & MILLING COMPANY

Amended -
U. S. Corporation Income Tax -
Fiscal Year Ended April 30, 1958

Statement re Provision for Depreciation

National Alfalfa Dehydrating & Milling Company was incorporated on May 4, 1956 for the purpose of the manufacture and sale of alfalfa meal. The company has acquired its fixed assets principally through the acquisition of existing plants from other companies. The five major acquisitions that have taken place since inception of the company are as follows:

	Date	Depreciable assets acquired
Pecos Valley Alfalfa Mill Company	5/17/46	$1,050,000
Denver Alfalfa Division	5/22/46	2,980,000
Cerophyl Laboratories, Inc.	4/ 1/54	1,050,000
Caro-green, Inc.	4/ 1/54	870,000
Saunders Mills, Inc.	2/11/59	1,100,000
		$7,050,000

At the time of the organization of the company, a firm of consulting engineers was engaged to appraise the properties acquired from Pecos Valley and the Denver Alfalfa Division and to arrive at the remaining useful life of these properties.

The Stone & Webster Engineering Corporation in its report determined the following average useful lives for various types of equipment:

	Life of properties if new	Remaining life of assets acquired
Buildings	25.35 years	20.14 years
Machinery	12.89 years	10.54 years
Harvesting equipment	7.05 years	5.47 years

On April 1, 1949 the company received a Revenue Agent's Report covering the examination of the fiscal years ended April 30, 1947 and April 30, 1948. A substantial portion of this report dealt with the problem of depreciation rates.

In conjunction with this examination an engineer revenue agent rendered a report dated November 29, 1948 with regard to depreciation.

The lives assigned to certain fixed asset classifications were as follows:

	Assets acquired from Pecos Valley & Denver Company	Asset additions to 4/30/48
Buildings	28.57 years	28.57 years
Machinery	10 years (minimum)	15 years
Harvesting equipment	(note)	(note)

Note: No mention was made in the revenue agent's report concerning the rates used on harvesting equipment except the general comment that "it appears that the depreciation rates taken and bases on the balance of the depreciable assets are approximately correct."

Schedule J-1
Page 5

At the end of the 1958 fiscal year the company's former president for reasons unknown to present management, directed the company controller to arbitrarily reduce its provision for depreciation for that year. There was no logical basis for the reduction. The company's original report to shareholders and the original U. S. income tax return reflected the following changes in depreciation rates:

	Rate used consistently prior to 1958, and as amended in 1958		Rate originally used in fiscal year ended April 30, 1958	
	%	Yrs. of life	%	Yrs. of life
Buildings	3-1/2	28.57	2-1/2	40
Machinery	6-2/3	15	4	25
Harvesting equipment	20	5	10	10

These changes resulted in a reduction in the provision for depreciation in the 1958 fiscal year in the amount of $169,758.

On March 12, 1959 Mr. W. A. Donnelly was elected president of the company, replacing the former president and the arbitrary change in depreciation rates made in the company's accounts in the fiscal year ended April 30, 1958 was discovered. Consequently, the published annual report to stockholders for the fiscal year ended April 30, 1959 not only showed the profit and loss statement for the fiscal year ended April 30, 1958, but restated this profit and loss statement (over the one formerly published) to eliminate this arbitrary change in depreciation. Similarly the financial statements which are required by law to be filed with the Securities and Exchange Commission are being amended to restate the 1958 depreciation provision as computed with the rates consistently used in prior years.

The company is similarly amending its U. S. corporation income tax return for the fiscal year ended April 30, 1958 to claim as a deduction a provision for depreciation as computed with the rates consistently used in prior years.

The company believes that the depreciation rates initially established at the time of the organization of the company by an outside firm of consulting engineers, as agreed to by the U. S. Treasury Department in subsequent years and as reflected in the amended U. S. corporation income tax return for the fiscal year ended April 30, 1958 represent a reasonable allowance for wear, tear and obsolescence of the property used in the trade or business as provided by Section 167 of the Internal Revenue Code of 1954.

In equating the reasonableness of these rates consideration should be given to the fact that the major portion of the company's fixed assets were acquired from other existing companies and therefore these assets were used rather than new when acquired. A brief description of these acquisitions prior to 1959 follows.

PECOS VALLEY

At the time of the organization of the company, substantially all of the alfalfa milling facilities of the Pecos Valley Alfalfa Mill Company were purchased. The statements of that company contained in the prospectus filed by National with the SEC in 1946 indicate that these assets were approximately 28% depreciated by 1946.

Other information contained in the prospectus indicates that one of the nine locations acquired was originally opened in 1910 and that a second location had been constructed prior to 1926. The remaining seven plants were originally constructed during the period between 1926 and 1942 according to the prospectus.

DENVER ALFALFA DIVISION

At the same time as the Pecos Valley acquisition, the company purchased the assets of the Denver Alfalfa Milling and Products Division of the Ralston Purina Company. Financial statements of this division contained in the 1946 prospectus indicate that these assets were approximately 55 per cent depreciated at the time of purchase by National.

Other information contained in the prospectus indicates that one of the mills purchased by National was built in 1908. By 1926 the Denver Company was operating sixteen plants. At the time of the sale to National in May 1946 the Denver Company was operating twenty-five plants.

CARO-GREEN, INC.

In 1954 the company purchased a storage facility in Omaha, Nebraska from Caro-green, Inc. Discussion with Kenneth Toma, company manager of the Omaha plant, revealed that the original elevator building was constructed in 1917 and that an addition to the building was made in the late 1920's. The conveyor system and certain other equipment in the elevator dates back to 1917 but a fairly substantial portion of the machinery and equipment was installed in 1952. Approximately $546,000 of the purchase price was allocated to the buildings.

CEROPHYL LABORATORIES, INC.

A storage facility and an alfalfa mill at Midland, Kansas and three other alfalfa mills in Kansas and Missouri were purchased from Cerophyl Laboratories, Inc. in 1954.

The following information as to the approximate age of these plants was obtained from W. Alex Donnelly, president of National (formerly president of Cerophyl Laboratories, Inc.).

The production facilities and dry storage warehouses at Midland, Kansas were between nine and fifteen years old at the time of acquisition by National and a number of the storage tanks were five or more years old.

The dehydrator drums and mill buildings at the other three mills were all eight to nine years old at the time of acquisition by National.

The company has made a study of the dispositions of buildings, machinery and harvesting equipment for the fiscal years ending April 30, 1954 through April 30, 1959 to determine the average period that the assets were held prior to disposition.

The method used in accumulating the data presented in the table below is as follows:

(1) The company's detailed listings of fixed asset dispositions were obtained.

(2) The abnormal dispositions from fire, windstorm, and sale to affiliated companies were deleted from the listings.

(3) The holding period to the nearest one-half year was multiplied times the cost of the asset to obtain the number of dollar-years that the asset was held.

(4) The total of the dollar-years for each year was accumulated and divided by the total cost of the asset dispositions for the year to arrive at the weighted-average life of the assets retired.

A summary of this study follows:

Schedule J-1
Page 7

WEIGHTED-AVERAGE LIFE OF FIXED ASSET DISPOSITIONS

	Fiscal 1954	Fiscal 1955	Fiscal 1956	Fiscal 1957	Fiscal 1958	Fiscal 1959	Period 5/1/53-4/30/59
Buildings	7.1	6.9	9.2	9.2	11.0	6.8	7.6
Machinery	4.9	7.4	8.0	7.8	7.2	5.7	6.7
Harvesting equip.	5.9	7.1	6.9	8.2	8.5	7.6	7.2

The following table will indicate the dollar amounts of the assets included in the study and also the aggregate gain or loss from these sales during the period May 1, 1953 through April 30, 1959.

	Cost of Assets Sold	Gain (Loss) on Sale
Buildings	$1,290,292	$(155,696)
Machinery	1,126,144	(62,413)
Harvesting equipment	326,645	40,110
Total	$2,743,081	$(177,999)

A comparison of the loss on sale of buildings for the period with the cost of these buildings indicates that approximately 12 per cent more depreciation should have been taken in total on the buildings. When this fact is related to the previous table indicating a weighted-average age of 7.6 years at the time of retirement, which is approximately 25 per cent of the life used by the company, it can be seen that an increase in the depreciation rate of between 40 and 50 per cent would be justified. Since the company has used a 3.5 per cent rate, this would indicate that a rate of approximately 5 per cent would be more appropriate.

A similar conclusion can be reached in connection with the machinery. In this instance, an additional 5.5% of depreciation would be needed to eliminate the loss. The equipment had been held an average of approximately 45 per cent of the life assigned by the

company. An increase in depreciation rate of approximately 12 per cent would be in order. This would result in an increased rate from the 6-2/3 per cent used by the company to approximately 7-1/2 per cent.

In the case of harvesting equipment, the above study indicates that there should be an increase in the useful life of this equipment from the 5 years used by the company to approximately 7 years.

One factor that has not been considered in the preceeding paragraphs is the factor of inflation which during the period of the study was such that gains reasonably could have been expected from the sales of fixed assets.

When all of these factors are considered, the company firmly believes that the depreciation rates consistently used in prior years and in this amended U. S. corporation income tax return for the fiscal year ended April 30, 1958 result in a reasonable allowance for wear and tear and obsolesence as provided by Section 167 of the Internal Revenue Code of 1954.

Schedule K

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY
Lamar, Colorado

Amended Return

Year Ended April 30, 1958

OTHER DEDUCTIONS

Other deductions per original return	$324,268.04
Add	
Amortization of discount on debentures issued - see Schedule K-1	37,037.00
Loss on disposition of Denver Alfalfa assets - see Schedule K-2	1,742.00
	$363,067.04

Schedule K-1

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY
Lamar, Colorado

Amended U. S. Corporation Income Tax Return

Year Ended April 30, 1958

STATEMENT RE AMORTIZATION OF DISCOUNT
ON DEBENTURES ISSUED

On July 23, 1957 the preferred stockholders of the company agreed to exchange their $50 par preferred stock for 18-year 5% sinking fund debentures. This exchange was treated as a taxable exchange by the preferred stockholders, as required by the Internal Revenue Code of 1954.

At the time of the exchange the fair market value of the preferred stock of the company was approximately $33 per share. This fair market value is measured by the average of the daily bid and asked prices of the preferred stock for the period July 15 to July 23, 1957, inclusive. Since this was a taxable exchange, the company is entitled to amortize the difference between the principal amount of the 18-year sinking fund debentures ($50 per share) and the fair market value of the property received in exchange (preferred stock with fair market value of $33 per share). This is as provided by section 1.61-12 of the Internal Revenue Code Regulations. Also see: American Smelting & Refining Company v. U. S. 130 Feb. 2d 883 and Southern Fertilizer & Chemical Co. v. Edwards, 55-1 U.S.T.C. Par. 49133.

Accordingly the company is amending its U. S. corporation income tax return for the fiscal year ended April 30, 1958 to include a deduction in the amount of $37,037 representing the pro rata portion of the total unamortized bond discount.

per Schedule M.

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY

Lamar, Colorado

U. S. Corporation Income Tax Return

Year Ended April 30, 1958

STATEMENT RE LOSS ON DISPOSITION OF

PECOS VALLEY AND DENVER ALFALFA ASSETS

Pecos Valley Assets

On May 17, 1948, National Alfalfa Dehydrating and Milling Company purchased for $1,600,000 in cash, certain assets from the Pecos Valley Alfalfa Mill Company. These assets consisted of 9 plants for processing alfalfa and related equipment.

At the date of acquisition National Alfalfa recorded on its books of account an amount of $546,810 (subsequently adjusted to $524,433) as "excess of purchase consideration paid over amounts at which plant is recorded in the accounts." This amount was amortized for book purposes until 1954 when the unamortized balance was charged to earned surplus. None of this amount has been claimed as a deduction in any year in the company's U. S. corporation income tax returns.

Since the acquisition of these properties, there have been certain technological changes in the alfalfa industry which have rendered the Pecos Valley properties obsolete and the company has since disposed of substantially all of these properties acquired in 1948.

At date of acquisition the 9 plants acquired from Pecos Valley had a total capacity of 108,000 tons and in the fiscal year ended April 30, 1959, the only remaining operating plant acquired with this acquisition produced only 3,141 tons.

In the first year of their operation while under the ownership of National Alfalfa, sun-cured alfalfa accounted for about 85% of the total production, whereas, during the fiscal year ended April 30, 1959, it accounted for about only 1% of the total production. A major portion of the plants acquired from Pecos Valley were geared primarily to the sun-cure type of operation. Furthermore, in the years following World War II, the plants in Arizona, Idaho and New Mexico were able to ship their production to the southeastern part of the United States by means of ocean transportation and, therefore, the freight costs were low. When these plants were no longer able to ship in this manner, the overland freight costs to the eastern markets were too high to permit profitable operations. Also a number of the plants acquired from Pecos Valley were disposed of because they were located in poor producing areas. The company is, therefore, entitled to claim as a deduction in the year of sale the pro rata portion of the cost of these plants not previously claimed as a deduction. The summary of this pro rata cost follows:

Plants sold in fiscal year ended	Pro rata portion of cost not previously deducted applicable to plants sold
4/30/52	$ 63,036*
4/30/55	131,109
4/30/56	54,279
4/30/57	37,130
4/30/59	147,156

*This year is barred by statute of limitations.

Denver Alfalfa assets

Similarly on May 22, 1946 National Alfalfa purchased twenty-five alfalfa plants from the Denver Alfalfa Milling and Products Division of the Ralston Purina Company for $3,875,000. At the date of acquisition National Alfalfa recorded on its books of account an amount of $855,549 (subsequently adjusted to $757,544) as "excess of purchase consideration paid over amounts at which plant is recorded in the accounts." National Alfalfa has similarly sold some of these plants and is claiming as a deduction in the years of sale the pro rata portion of the cost of these plants not previously claimed as a deduction. The summary of this pro rata cost follows:

Schedule K-2
Page 4 of 4

Plants sold in fiscal year ended	Pro rata portion of cost not previously deducted applicable to plants sold
4/30/48	$16,893*
4/30/54	76*
4/30/55	19,999
4/30/56	31,287
4/30/57	2,045
4/30/58	1,742
4/30/59	81,363

*This year barred by statute of limitations.

Schedule M

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY
Lamar, Colorado

Amended U. S. Corporation Income Tax Return

Year Ended April 30, 1958

RECONCILIATION OF TAXABLE INCOME AND
ANALYSIS OF CHANGES IN EARNED SURPLUS

Line No.			
	Net loss per books		$(327,508.35)
10	Unallowable contributions due to loss		442.00
11	Federal income tax		243.91
13	Premiums on insurance on officer's life		3,421.25
6	Accrual of refundable federal income tax	1957	(167,389.38)
6	Overaccrual of income taxes	1957	(36,723.17)
6	Depreciation allowable in excess of amount per books		(169,758.29)
6	Amortization of discount on debentures issued - Schedule K-1		(37,037.00)
	Loss on disposition of Denver Alfalfa assets - Schedule K-2		(1,742.00)
2	Loss for tax purposes		$(736,051.03)
1	Surplus at end of preceding taxable year		$ 95,633.91
	Net loss per books		(327,508.35)
2	Deficit at end of taxable year		$(231,874.44)

Schedule Y

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY
Lamar, Colorado

Amended U. S. Corporation Income Tax Return

Year Ended April 30, 1958

DISPOSITION OF NET OPERATING LOSS DEDUCTIONS OF PRIOR YEARS

	Year Ended April 30,			
	1954	1955	1956	1957
Taxable income (loss) per original return	$ 71,350.85	$481,521.08	$(775,290.87)	$556,381.37
Adjustments - Loss on disposal of Pecos Valley assets - Schedule K-2		(131,109.00)	(54,279.00)	(37,130.00)
Loss on disposal of Denver Alfalfa assets - Schedule K-2		(19,999.00)	(31,287.00)	(2,045.00)
Adjusted taxable income	71,350.85	330,413.08	(860,856.87)	517,206.37
Carry back of 1956 loss to 1955 and 1954	(71,350.85)	(330,413.08)	401,763.93	
Carry forward of unused 1956 loss to 1957			459,092.94	(459,092.94)
Net remaining income to which 1958 loss is partially applied	- 0 -	- 0 -	- 0 -	$ 58,113.43

STIPULATION EXHIBIT 9–I

Corporation Income Tax Return (Form 1120) for Taxable Year Ending April 30, 1967.

FORM 1120

U.S. Treasury Department
Internal Revenue Service

U.S. Corporation Income Tax Return

For the year January 1–December 31, 1966, or other taxable year beginning MAY 1, 1966, and ending APRIL 30, 1967

(PLEASE TYPE OR PRINT)

1966

Check if a—
A Sole proprietorship ☐ or partnership ☐ electing under sec. 1361 to be taxed as a corporation.
B Consolidated return ☐
C Personal Holding Co. ☐
D Business code no. (see instr.) 2040

44-0374927 1967 DD 43 04
NATIONAL ALFALFA DEHYDRATING & MILLING CO.
CLOVERLEAF 1 BLDG 6811 W 63RD ST
PO BOX 500
SHAWNEE MISSION KANS 66201

E Employer Identification No. 44-0374927
F County in which located. JOHNSON
G Enter total assets from line 14 Sch. L (see instructions B) $ 6,915,661.30

IMPORTANT—All applicable lines and schedules must be filled in. If the lines on the schedules are not sufficient, see instruction Q.

GROSS INCOME	1 Gross receipts or gross sales ..... Less: Returns and allowances	10,175,170.97
	2 Less: Cost of goods sold (Schedule A) and/or operations (attach schedule)	6,464,608.44
	3 Gross profit	3,710,522.53
	4 Dividends (Schedule C)	
	5 Interest on obligations of the United States and U.S. instrumentalities	
	6 Other interest	13,767.97
	7 Rents	12,321.79
	8 Royalties	
	9 Net gains (losses)—(separate Schedule D)	(39,641.10)
	10 Other income (attach schedule)	6,435.53
	11 TOTAL income—Add lines 3 through 10	3703,406.67
DEDUCTIONS	12 Compensation of officers (Schedule E)	101,950.10
	13 Salaries and wages (not deducted elsewhere)	165,535.03
	14 Repairs (do not include cost of improvements or capital expenditures)	625,083.88
	15 Bad debts (Schedule F if reserve method is used)	44,081.46
	16 Rents	286,480.30
	17 Taxes (attach schedule)	269,524.54
	18 Interest	149,318.39
	19 Contributions (attach schedule—see instructions for limitation)	75.00
	20 Losses by fire, storm, shipwreck, other casualty, or theft (attach schedule)	
	21 Amortization (attach schedule)	
	22 Depreciation (Schedule G)	670,773.55
	23 Depletion (attach schedule)	
	24 Advertising	12,137.17
	25 (a) Pension, profit-sharing, stock bonus, annuity plans (see instructions)	
	(b) Other employee benefit plans (see instructions)	19,268.96
	26 Other deductions (attach schedule)	434,358.74
	27 TOTAL deductions in lines 12 through 26	2778,587.12
	28 Taxable income before net operating loss deduction and special deductions (line 11 less line 27)	924,819.55
	29 Less: (a) Net operating loss deduction (see instructions—attach schedule) $800,319.75	
	(b) Special deductions (Schedule I)	(800,319.75)
	30 Taxable income (line 28 less line 29)	124,499.80
TAX AND PAYMENTS	31 TOTAL income tax (Schedule J)	34,981.98
	32 Credits: (a) Tax paid with Form 7004 application for extension (attach copy)	
	(b) Payments and credits on 1966 declaration of estimated tax	
	(c) Credit from regulated investment companies (attach Form 2439)	
	(d) Credit for U.S. tax on nonhighway gas. and lub. oil (attach Form 4136) 3715.50	3715.50
	33 If tax (line 31) is larger than credits (line 32), the balance is TAX DUE. Enter balance here →	31,266.48
	34 If tax (line 31) is less than credits (line 32) . . . . . Enter the OVERPAYMENT here →	
	35 Enter amount of line 34 you want: Credited on 1967 estimated tax ..... Refunded	

PAY CASH

REC'D WITH REMITTANCE JUL 18 1967 WICHITA KS DIR. INT. REV.

48

To ascertain interest period, subtract, thus: 4 months 18 days

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief it is true, correct, and complete. If prepared by a person other than taxpayer, his declaration is based on all information of which he has any knowledge.

CORPORATE SEAL

July 17, 1967 (Date) — (Signature of officer) — Secretary (Title)

July 14, 1967 (Date) — Price Waterhouse & Co. (Individual or firm signature of preparer) — 2900 Commerce Tower Bldg. Kansas City, Missouri 64105 (Address)

659—16—70006-1

Form 1120 (1966) [Page 2]

Schedule A—COST OF GOODS SOLD (See Instruction 2)

1 Inventory at beginning of year	
2 Merchandise bought for manufacture or sale	
3 Salaries and wages	
4 Other costs (attach schedule)	
5 Total	SCHEDULE ATTACHED
6 Less inventory at end of year	
7 Cost of goods sold—Enter on line 2, page 1	6,464,608.44

Method of inventory valuation

LOWER OF COST OR MARKET

Schedule C—DIVIDENDS (See instruction 4)

1 Domestic corporations subject to 85% deduction	
2 Certain preferred stock of public utilities	
3 Foreign corporations subject to 85% deduction	
4 Other dividends from foreign corporations	
5 Income from controlled foreign corporations (attach Form 3646)	
6 Foreign dividend gross-up (section 78)	
7 Qualifying dividends from affiliated groups (section 243(b))	
8 Other	
9 Total—Enter on line 4, page 1	

Schedule E—COMPENSATION OF OFFICERS (See page 5 of instructions)

1. Name, address, and social security number of officer	2. Title	3. Time devoted to business	Percent of corporation stock owned 4. Common	5. Preferred	6. Amount of compensation	7. Expense account allowances
SCHEDULE ATTACHED						
Total compensation of officers—Enter here and on line 12, page 1					101,950.10	

Schedule F—BAD DEBTS—RESERVE METHOD (See Instruction 15)

1. Year	2. Trade notes and accounts receivable outstanding at end of year	3. Sales on account	Amount added to reserve 4. Current year's provision	5. Recoveries	6. Amount charged against reserve	7. Reserve for bad debts at end of year
1961						
1962						
1963						
1964						
1965						
1966						

Schedule G—DEPRECIATION (See Instruction 22)

Taxpayers using Revenue Procedure 62-21: Make no entry in column 2, enter the cost or other basis of assets held at end of year in column 3, and enter the accumulated depreciation at end of year in column 4.

1. Group and guideline class or description of property	2. Date acquired	3. Cost or other basis	4. Depreciation allowed or allowable in prior years	5. Method of computing depreciation	6. Life or rate	7. Depreciation for this year
1 Total additional first-year depreciation (do not include in items below)						2000.00
Buildings						
Furniture and fixtures						
Transportation equipment						
Machinery and other equipment						
Other (specify)						
SCHEDULE ATTACHED						670,773.55
2 Totals						
3 Less amount of depreciation claimed in Schedule A and elsewhere on return						
4 Balance—Enter here and on line 22, page 1						670,773.55

Schedule H—SUMMARY OF DEPRECIATION

	Straight line	Declining balance	Sum of the years-digits	Units of production	Additional first-year (section 179)	Other (specify)	Total
1 Under Rev. Proc. 62-21							
2 Other	540,392.49	128,381.06			2000.00		670,773.55

o60—10—79006-2

524-785 O - 73 (Face blank p. 50) No. 3

SCHEDULE D (Form 1120)
U.S. Treasury Department
Internal Revenue Service

Gains and Losses From Sales or Exchanges of Property

1966

Name and address

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY 6811 WEST 63 RD ST. OVERLAND PARK, KANSAS

PART I—GAIN FROM DISPOSITION OF DEPRECIABLE PROPERTY UNDER SECTIONS 1245 AND 1250—Assets Held More Than 6 Months—Where double headings appear, use the first heading for section 1245 and the second heading for section 1250.

a. Kind of property (if necessary, attach statement of descriptive details not shown below—write 1245 or 1250 to indicate type of asset)	b. Date acquired (mo., day, yr.)	c. Date sold (mo., day, yr.)	d. Gross sales price	e. Cost or other basis, cost of subsequent improvements (if not purchased, attach explanation) and expense of sale
1 MACHINERY	VARIOUS	VARIOUS	9177.00	31933.69
AUTOS AND TRUCKS	VARIOUS	VARIOUS	1449.65	2170.90
FURNITURE AND FIXTURES	VARIOUS	VARIOUS	370.00	2271.86

f. Depreciation allowed (or allowable) since acquisition		g. Adjusted basis (e less sum of f-1 and f-2)	h. Total gain (d less g)	i. Ordinary gain (lesser of f-2 or h) — OR — (see instructions)	j. Other gain (h less i)
f-1. Prior to January 1, 1962 — OR — Prior to January 1, 1964	f-2. After December 31, 1961 — OR — After December 31, 1963				
1578.93	13760.41	2391.35	6785.65	6785.65	
677.12	1349.55	144.23	1305.42	1305.42	
2271.86	-0-	-0-	370.00	-0-	370.00
2 Total ordinary gain. Enter here and on line 11 and identify as gain from Part I				8091.07	
3 Total other gain. Enter here and on line 4 and identify as gain from Part I					370.00

PART II—SALE OR EXCHANGE OF PROPERTY UNDER SECTION 1231

a. Kind of property (if necessary, attach statement of descriptive details not shown below)	b. Date acquired (mo., day, yr.)	c. Date sold (mo., day, yr.)	d. Gross sales price	e. Depreciation allowed (or allowable) since acquisition	f. Cost or other basis, cost of subsequent improvements (if not purchased attach explanation) and expense of sale	g. Gain or loss (d plus e less f)
4 GAIN FROM PART I						370.00
SCHEDULE ATTACHED						(48,102.17)
5 Total (If gain, enter on line 9; If loss, enter on line 11. Identify as gain or loss from Part II.)						(47,732.17)

PART III—CAPITAL ASSETS
Short-Term Capital Gains and Losses—Assets Held Not More Than 6 Months

6						
7 Unused capital loss carryover (attach statement)						
8 Total of short-term capital gains or losses or difference between short-term capital gains and losses						

Long-Term Capital Gains and Losses—Assets Held More Than 6 Months

9						
10 Total of long-term capital gains or losses or difference between long-term capital gains and losses						

PART IV—PROPERTY OTHER THAN CAPITAL ASSETS

11 GAIN FROM PART I						8091.07
LOSS FROM PART II						(47,732.17)
12 Total net gain (or loss). Enter here and on line 15						(39,641.10)

530—16—T (287-1

PART V—TOTAL SCHEDULE D GAINS AND LOSSES

13 Enter excess of net short-term capital gain (line 8) over net long-term capital loss (line 10)	
14 Enter excess of net long-term capital gain (line 10) over net short-term capital loss (line 8)	
15 Net gain (loss) from property other than capital assets (line 12)	(39,641.10)
16 Total of lines 13, 14, and 15. Enter here and on Form 1120, page 1, line 9	(39,641.10)

Alternative Tax Computation

17 Taxable income (line 30, page 1, Form 1120)	
18 Net long-term capital gain reduced by any net short-term capital loss (line 14)	
19 Line 17 less line 18	
20 Surtax exemption (line 19, $25,000, or amount apportioned under section 1561, whichever is lesser)	
21 Line 19 less line 20	
22 25 percent of line 18	
23 22 percent of line 19	
24 26 percent of line 21	
25 If multiple surtax exemption is elected under section 1562, enter 6 percent of line 20	
26 Alternative tax—Add lines 22 through 25. If applicable, enter here and on line 5, Schedule J, Form 1120, and write "alt." in the margin to the right of the entry.	

INSTRUCTIONS (Continued from reverse side of original)

Gains and losses from involuntary conversion and from the sale or exchange of certain property used in the trade or business.—The term "property used in the trade or business," as used in section 1231, means property which has been held more than 6 months, which is used in the trade or business, and which is either real property or property subject to depreciation under section 167, and which is not (a) property of a kind which would properly be includible in inventory if on hand at the close of the taxable year, (b) property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business, or (c) certain copyrights or similar properties. The term includes timber, coal, and domestic iron ore to which section 631 applies as well as unharvested crops to which section 1231(b)(4) applies. The term also includes livestock (but not poultry) held for draft, breeding, or dairy purposes and held for 12 months or more from the date of acquisition.

Section 1231 provides special treatment for the gains and losses upon the sale or exchange of "property used in the trade or business" and upon the compulsory or involuntary conversion of (1) such property and (2) capital assets held for more than 6 months. Such gains and losses are treated as gains and losses from the sale or exchange of capital assets held for more than 6 months, if the aggregate of such gains exceeds the aggregate of such losses. If, however, the gains do not exceed the losses, such gains and losses shall not be treated as gains and losses from the sale or exchange of capital assets.

In determining whether gains do or do not exceed losses, it is necessary to include the gains and losses to the extent that they would be included if they were all ordinary gains and losses. The limitation of section 1211 on the deductibility of capital losses does not operate to exclude any such losses from the computation as to the excess of gains over losses, but all such losses are included in full. The total shown on line 5 determines whether the items reflected therein represent a long-term capital gain or an ordinary loss. The total must be entered on line 9 or line 11, whichever is applicable.

For special treatment of gain or loss upon the cutting of timber, or upon the disposal of timber, coal, or domestic iron ore under a contract by which the owner retains an economic interest in the timber, coal, or iron ore, see section 631.

Long-term capital gains from regulated investment companies.—Include in income as a long-term capital gain the amount the corporation has been notified constitutes its share of the undistributed capital gains of a regulated investment company.

Alternative tax.—If the net long-term capital gain exceeds the net short-term capital loss, or if there is only a net long-term capital gain, section 1201 imposes an alternative tax in lieu of the normal tax and surtax imposed upon taxable income, if any, only if such tax is less than the tax imposed by section 11 (relating to normal tax and surtax on corporations), sections 821 and 831 (relating to normal tax and surtax on insurance companies, other than life insurance companies), or section 511(a)(1) (relating to taxation of business income of certain organizations described in section 511(a)(2)). The alternative tax is the sum of (1) a partial tax, computed at the normal tax and surtax rates on the taxable income decreased by the excess of net long-term capital gain over net short-term capital loss, and (2) 25 percent of such excess.

If the corporation computes an alternative tax under section 1201 and is entitled to special deductions for dividends received (sections 243, 244, and 245), the special deduction for dividends paid (section 247), the special deduction for a Western Hemisphere trade corporation (section 922), or the special deduction for a China Trade Act corporation (section 941), such special deductions are to be based upon taxable income including the excess of net long-term capital gain over net short-term capital loss.

Bonds, etc., losses of banks.—In the case of a bank, as defined in section 581, if losses from sales or exchanges of bonds, debentures, notes, or certificates, or other evidences of indebtedness, issued by any corporation (including one issued by a government or political subdivision thereof) exceed the gains from such sales or exchanges, such excess shall be considered as an ordinary loss and deductible in full. Section 582.

Dealers in securities. Capital gains and ordinary losses.—Under the provisions of section 1236, gain by a dealer in securities from the sale or exchange of a security, as defined in section 1236, shall in no event be considered as gain from the sale or exchange of a capital asset unless (a) the security was, before the expiration of the thirtieth day after the date of its acquisition, clearly identified in the dealer's records as a security held for investment; and (b) the security was not, at any time after the expiration of such thirtieth day, held by the dealer primarily for sale to customers in the ordinary course of trade or business. A loss from the sale or exchange of a security shall be considered a capital loss if the security was clearly identified in the dealer's records as a security held for investment.

Short sales of capital assets.—For rules regarding tax consequences of certain short sales of stock or other securities (including those dealt with on a "when issued" basis), and transactions in commodity futures, see section 1233.

Instructions for insurance companies using this schedule.—Companies taxable under section 831 and having losses from capital assets sold or exchanged in order to obtain funds to meet abnormal insurance losses, etc., shall attach a schedule corresponding to Schedule A-3, Form 1120M. For companies taxable under section 821, all references to "line" numbers, Form 1120, shall be considered as references to the appropriate "line" on Form 1120M.

450—18—70287-1 GPO

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY
(44-0374927)

INCOME TAX RETURN - YEAR ENDED APRIL 30, 1967

COST OF GOODS SOLD

INVENTORY - BEGINNING OF YEAR		$ 563 545 60
PURCHASES OF HAY, MEAL, OIL FOR MEAL, SACKS, ETC.		2 805 916 55
WAGES AND SALARIES		1 603 319 36
OTHER COSTS —		
FREIGHT	$ 658 035 33	
DEHYDRATING FUEL	933 191 67	
POWER	373 366 87	
INSURANCE	100 293 12	
TRAVEL	29 510 5	
STORAGE GAS	9 784 37	
FARM OPERATIONS	23 832 71	
MISCELLANEOUS	33 633 86	2 135 088 98
		7 107 870 49
LESS: INVENTORY - END OF YEAR		643 262 05
		$ 6 464 608 44

OTHER INCOME

GAIN ON REDEMPTION OF DEBENTURES	
GRAIN ELEVATOR COMPANY DEBENTURES ASSUMED ON MERGER	$ 6 037 70
MISCELLANEOUS	397 83
	$ 6 435 53

National Alfalfa Dehydrating and Milling Company
(44-0374927)

Income Tax Return - Year Ended April 30, 1967

Compensation of Officers

Name, Address and Social Security Number of Offical	Official Title	Time Devoted To Business	Percent of Common Stock Owned	Amount of Compensation	Expense Account Allowance
S. V. Tuttas (389-09-9818) 4545 Wornall Road, Kansas City, Missouri Apt. 102	Chairman of Board & President	As Required	3.00	40 000 02	8 287 60
D. E. Merrick (301-03-2952) 6643 Woodson, Shawnee Mission, Kansas	Vice-President	As Required	0.43	21 000 04	5509 49
G. J Polony (106-03-5829) 6728 W. 83rd, Overland Park, Kansas Apt. 305	Vice-President	As Required	0.18	14 700 04	2 980 20
W. D Shackelford (523-01-0833) 5014 W 68th Terrace, Shawnee Mission, Ks.	Secretary	As Required	0.04	13 650 00	316 13
F. H Read (523-01-2781) 8205 Hamilton Drive Overland Park, Kansas	Treasurer	As Required	0.09	12 600 00	261 87
				101 950 10	

Contributions

Mercy Hospital	$ 25 00
Junior Achievement	50 00
	$ 75 00

Taxes

Payroll Taxes	120 633 48
Licenses, Real Estate, etc	138 429 74
State and Local Income Taxes	10 461 32
	269 524 54

NATIONAL MEDICAL DENTAL HOSPITAL AND MEDICAL COMPANY

44-0374927

INCOME TAX RETURN - YEAR ENDED 11/30/57

DEPRECIATION

Group and guideline class or description of property	Date acquired	ASSETS: Cost or other basis at beginning of year	Additions at cost	Retirements and transfers	Balance at end of year	Method	Rate or class life	DE: Allowed in prior years	Deprecia this y
BUILDINGS	VARIOUS	1695145 63	60540 15	(70392 04)	1685299 04	ST. LINE	3 1/2%	129644 99	64 65
	VARIOUS		55059 63		55059 63	D.D. BALANCE	3 1/2%		192
TANKS	VARIOUS	1736919 75			1736919 75	ST. LINE	4%	765788 89	63709
			72970 81		72970 81	D.D. BALANCE	4%		2918
MACHINERY AND EQUIPMENT	VARIOUS	5810263 52	18872 01	(252337 49)	5576798 04	ST. LINE	5 2/3 20%	3620631 61	349
	VARIOUS		807924 36		807924 36	D.D. BALANCE	5 2/3 - 20%		114420
FURNITURE AND FIXTURES	VARIOUS	100805 83		(3321 86)	97483 97	ST. LINE	10%	76 951 75	3773
	VARIOUS		9877 45		9877 45	D.D. BALANCE	10%		987
AUTOS AND TRUCKS	VARIOUS	143998 02	3176 57	(2246 58)	144928 01	ST. LINE	25%	69462 19	28510
	VARIOUS		40507 86		40507 86	D.D. BALANCE	25%		10126
CONSTRUCTION IN PROGRESS	VARIOUS	240583 13	(197546 82)		43036 31				
		9727715 88	831388 62	(328298 67)	10230805 83			5262477 52	640330

AMORTIZATION OF ADD BACK

INVESTMENT CREDIT 294

EXCESS TAX [illegible] DEPRECIATION 30285

670773

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY
44-0374927
INCOME TAX RETURN - YEAR ENDED 11/30/57

DEPRECIATION

ate ired	ASSETS: Cost or other basis at beginning of year	ASSETS: Additions at cost	ASSETS: Retirements and transfers	ASSETS: Balance at end of year	Method	Rate or class life	DEPRECIATION RESERVE: Allowed in prior years	DEPRECIATION RESERVE: Depreciation this year	DEPRECIATION RESERVE: Retirements and transfers	DEPRECIATION RESERVE: Balance at end of year
DOS	1695145 63	60540 15	(70392 74)	1645299 04	ST. LINE	3½%	129644 99	64652 40	(42554 33)	751 42 06
DOS		55059 63		55059 63	D. D. BALANCE	3½%		1927 12		1927 12
DOS	1736919 75			1736919 75	ST. LINE	4%	765788 89	63705 45		829494 34
		72970 81		72970 81	D. D. BALANCE	4%		2918 84		2918 84
DOS	5810263 52	18872 61	(352337 49)	5576798 64	ST. LINE	5⅔ - 20%	3620631 61	344 [illegible] 14	(208057 96)	3761627 97
DOS		807924 36		807924 36	D. D. BALANCE	5⅔ - 20%		114420 34		114420 34
DOS	100805 83		(3321 86)	97483 97	ST. LINE	10%	76751 76	3778 22	(2701 66)	77828 12
DOS		9877 45		9877 45	D. D. BALANCE	10%		987 80		987 80
DOS	143998 02	3176 57	(2246 58)	144928 01	ST. LINE	25%	69462 19	28910 01	(2026 67)	96345 53
DOS		40507 86		40507 86	D. D. BALANCE	25%		10126 96		10126 96
DOS	240583 13	(197546 82)		43036 31						
	9727715 88	831388 62	(328298 67)	10230805 83			5252479 62	640330 58	(255540 92)	6037269 48

AMORTIZATION OF ADD BACK

INVESTMENT CREDIT 204 00

EXCESS TAX OVER [illegible] DEPRECIATION 30238 67

70773 55

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY
(44-0374927)

INCOME TAX RETURN - YEAR ENDED APRIL 30, 1967

OTHER EMPLOYEE BENEFITS - INFORMATION

1. NATURE OF BENEFITS	LIFE INSURANCE	MAJOR MEDICAL	TOTAL
2. METHOD OF FINANCING	INSURED	INSURED	
3. DEDUCTION	10 611 44	8 657 52	19268 96
4. EMPLOYEE CONTRIBUTIONS	5927 96	11 040 00	
5. NUMBER OF EMPLOYEES COVERED	136	123	
NUMBER OF EMPLOYEES AT APRIL 30, 1967 -			181

RECONCILIATION OF INCOME PER BOOKS WITH INCOME PER RETURN

LINE PER SCHEDULE M-1		
8	AMORTIZATION OF DISCOUNT ON DEBENTURES (SEE STATEMENT ATTACHED)	109804 00
	EXCESS TAX DEPRECIATION OVER RECORDED BOOK DEPRECIATION	96765 22
	LOSS ON DISPOSITION OF DENVER ALFALFA ASSETS (SEE STATEMENT ATTACHED)	9318 00
	AMORTIZATION OF BOND EXPENSE	5602 00
	AMORTIZATION OF DISALLOWED PRIOR YEARS RENT EXPENSE	801 00
	ADDITIONAL DEPRECIATION RESULTING FROM ADD BACK OF INVESTMENT CREDIT	204 00
	DECREASE IN AUDIT EXPENSE - ACCRUAL	1500 00
		223994 22

524-785 O - 73 (Face blank p. 50) No

National Alfalfa Dehydrating and Milling Company
(44-0374927)

Income Tax Return - Year Ended April 30, 1967

Other Deductions

Travel			107655 02
General			59769 43
Telephone and Telegraph			50478 33
Legal and Audit Fees			25334 21
Commissions and Brokerage			35228 83
Stock Expense			898 13
Postage			6825 05
Secured Loan Costs			5205 68
Moving Costs			484 38
Registration Fees			324 81
Dues and Subscriptions			265 09
Collection Expense			175 78
Loss on Disposition of Denver Alfalfa Assets (See Statement Attached)			318 00
Amortization of Discount on Debentures (see statement attached)			
Pro-rata amortization on debentures outstanding		10980 00	
on debentures retired		98824 00	
Gain on purchase of debentures		(2345 00)	107459 00
Amortization of Bond Issue			560 00
			434 358 74

Schedule D Sale or Exchange of Property under Section 1231

Kind of Property	Date Purchased	Date Sold	Sales Price	Depreciation	Cost	Gain (Loss)
Line 4						
Land	5-24-46	2-28-67	600 00		500 00	-0-
Building	Various	Various	14870 00	42654 93	70 39274	(12967 81)
Machinery	Various	Various	6900 00	178515 12	720403 80	(34988 68)
Autos and Trucks	Various	Various			75 68	(75 68)
Furniture and Fixtures	Various	Various	350 00	630 00	1050 00	(700 00)
						(48102 17)

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY

(44-0374927)

INCOME TAX RETURN - YEAR ENDED APRIL 30, 1967

LOSS ON DISPOSITION OF DENVER ALFALFA ASSETS

On May 22, 1946, the taxpayer purchased from the Denver Alfalfa Milling and Products Division of Ralston Purina Company, twenty-five alfalfa plants for $3,875,000. At the date of acquisition the taxpayer recorded in its accounts an amount of $757,544 as "excess of purchase consideration paid over amounts at which plant is recorded in the accounts."

This amount (i.e., $757,544) was amortized in the accounts (but not for tax purposes) until 1954 when the unamortized balance was charged to earned surplus.

Since the acquisition of this property in 1946, there have been certain technological changes in the alfalfa industry which have rendered the property obsolete, and the taxpayer has subsequently disposed of substantially all of the properties.

The taxpayer is, therefore, claiming as a tax deduction in the year of disposition the pro-rata portion of the cost of such plants not previously deducted; and he claims in the year ended April 30, 1967 a loss on disposition in the amount of $9,318.

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY

(44-0374927)

INCOME TAX RETURN - YEAR ENDED APRIL 30, 1967

On July 23, 1957 the preferred stockholders of the Company agreed to exchange their $50 par preferred stock for 18-year 5% sinking fund debentures. This exchange was treated as a taxable exchange by the preferred stockholders, as required by the Internal Revenue Code of 1954.

At the time of exchange the fair market value of the preferred stock of the Company was approximately $33 per share. This fair market value is measured by the average of the daily bid and asked prices of the preferred stock for the period July 15 to July 23, 1957, inclusive. Since this was a taxable exchange, the Company is entitled to amortize the difference between the principal amount of the 18-year sinking fund debentures ($50 per share) and the fair market value of the property received in exchange (preferred stock with fair market value of $33 per share). This is as provided by Section 1.61-12 of the Internal Revenue Code Regulations. Also see: American Smelting & Refining Company v. U.S. 130 Fed. 2d 883 and Southern Fertilizer & Chemical Co. v. Edwards, 55-1 USTC Para. 49133.

During the year ended April 30, 1967, the corporation repurchased $204,050.00 face value of these debentures for $201,705.00. At April 30, 1966 the unamortized discount related to these bonds being repurchased was $98,824.00.

In addition, the taxpayer is deducting in the year ended April 30, 1967, $10,980.00 which represents a pro-rata amortization of the discount attributable to the bonds still outstanding at April 30, 1967.

REVISED IN ACCORDANCE WITH NEW LAW RELATING TO SUSPENSION OF INVESTMENT CREDIT

FORM 3468 (REVISED)
U.S. Treasury Department
Internal Revenue Service

Computation of Investment Credit

TO BE ATTACHED TO YOUR TAX RETURN
For the year January 1–December 31, 1966, or other taxable year beginning MAY 1, 1966, ending APRIL 30, 19 67

1966

Name and address
NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY
QUENICAF I BLDG 6811 W 63RD STREET P.O. Box SHAWNEE MISSION KANSAS 66201

1 Investment in new and used property including investment in suspension period property
NOTE: Include your share of investment in property by a partnership, estate, trust, small business corporation, or lessor.

Type of property	Line	(1) Life years	(2) Cost or basis	(3) Applicable percentage	(4) Investment (Column 2 x column 3)
NEW PROPERTY	(a)	4 or more but less than 6	688,019.66	33⅓	229,339.89
	(b)	6 or more but less than 8	200,629.91	66⅔	133,753.28
	(c)	8 or more	583,943.81	100	583,943.81
USED PROPERTY (See instructions for dollar limitation)	(d)	4 or more but less than 6	8035.36	33⅓	2678.43
	(e)	6 or more but less than 8		66⅔	
	(f)	8 or more	11274.25	100	11274.25

2 Total investment—Add lines 1(a) through (f)		960,989.66
3 (a) Amount of investment on line 2 which is attributable to suspension period property		231,336.60
(b) Amount of exemption from suspension period property (amount of investment in suspension period property in column 2, line 1, which is selected to be treated as qualified property—not to exceed $20,000)	20,000.00	

(c) Enter in column 2 below the amount of investment on line 3(b) according to life years:

(1) Life years	(2) Cost or basis	(3) Applicable percentage	(4) (Column 2 x column 3)
4 or more but less than 6		33⅓	
6 or more but less than 8		66⅔	
8 or more	20,000.00	100	20,000.00

(d) Total of column 4	20,000.00
4 Line 3(a) less line 3(d)	211,336.60
5 Total qualified investment—Line 2 less line 4	749,653.60
6 Tentative investment credit—7% of line 5 (3% for public utility property)	52,475.75
7 Carryback and carryover of unused credit(s) (attach computation)	107,854.00
8 TOTAL—Add lines 6 and 7	160,329.75

COMPUTATION OF TAX FOR PURPOSES OF LIMITATION

9 (a) Individuals—Enter amount from line 12, page 1, Form 1040	
(b) Estates and trusts—Enter amount from line 25 or 26, page 1, Form 1041	53,259.91
(c) Corporations—Enter amount from line 7, Tax Computation Schedule, Form 1120	
10 Individuals, estates and trusts: (a) Foreign tax credit	
(b) Retirement income credit	
11 Total—Add lines 10(a) and (b)	
12 Line 9 less line 11	53,259.91

LIMITATION BASED ON AMOUNT OF TAX

(Married persons filing separately, affiliated groups, estates and trusts, see instruction 13)

13 (a) Enter amount on line 12 or $25,000, whichever is lesser	25,000.00
(b) If line 12 is in excess of $25,000, enter 25% of the excess 28,561.64% x 28,259.91	8,071.49
14 Total—Add lines 13(a) and (b)	33,071.49
15 Less 7% of line 4 (3% for public utility property)	14,793.56
16 Line 14 less line 15	18,277.93
17 Investment credit—Enter amount on line 8 or line 16, whichever is lesser	18,277.93

SCHEDULE A

If any part of your investment in 1 above was made by a partnership, estate, trust, small business corporation, or lessor complete the following:

Name (Partnership, estate, trust, etc.)	Address	Property: New	Property: Used	Life years
RAPID WAYS, INC.	EXCELSIOR SPRINGS, MISSOURI	$ 207,314.15	$	4-6
RAPID WAYS, INC.	EXCELSIOR SPRINGS, MISSOURI	209,629.91		6-8
RAPID WAYS, INC.	EXCELSIOR SPRINGS, MISSOURI	133,368.84		8 OR MORE

10—70811-1

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY
(44-0374927)
INCOME TAX RETURN - YEAR ENDED APRIL 30, 1967

INVESTMENT TAX CREDIT CARRYOVER

	FISCAL YEAR ENDED APRIL 30,					
	1962	1963	1964	1965	1966	TOTAL
INVESTMENT TAX CREDIT	8065	8841	37288	42566	16453	113213
INVESTMENT TAX CREDIT ON STORAGE TANKS; CREDIT NOT TAKEN IN 1966					1610	1610
LESS: INVESTMENT TAX CREDIT RESULTING FROM EARLY DISPOSITIONS —						
PRIOR FISCAL YEARS	1188	95	190	177		1649
CURRENT FISCAL YEAR	210	484	217	4296	112	5319
	6667	8262	36881	38093	17951	107854

COMPUTATION OF NET OPERATING LOSS DEDUCTION

TAX LOSS FOR YEAR ENDED APRIL 30, 1962	9368700
APRIL 30, 1965	9346700
VACATION PAY ERRONEOUSLY NOT DEDUCTED IN YEAR ACCRUED (APRIL 30, 1965)	177800
TAXABLE INCOME FOR YEAR ENDED APRIL 30, 1966	(2297925)
NET OPERATING LOSS DEDUCTION FOR YEAR ENDED APRIL 30, 1967	8003975

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY

44-0374927

Page 4

Schedule L—BALANCE SHEETS

ASSETS	Beginning of taxable year (A) Amount	Beginning of taxable year (B) Total	End of taxable year (C) Amount	End of taxable year (D) Total
1 Cash		1,082,412.23		1,005,610.42
2 Trade notes and accounts receivable	612,550.37		529,722.24	
(a) Reserve for bad debts	30,000.00	582,550.37	30,000.00	359,722.24
3 Inventories		562,545.60		672,244.65
4 Gov't obligations: (a) U.S. and instrumentalities				
(b) State, subdivisions thereof, etc.				
5 Other current assets (attach schedule)		181,113.44		127,241.27
6 Loans to stockholders				
7 Mortgage and real estate loans				
8 Other investments (attach schedule)				
9 Buildings and other fixed depreciable assets	9,727,715.25		10,230,805.83	
(a) Less accumulated depreciation	5,262,477.52	4,465,237.36	5,580,742.93	4,650,062.90
10 Depletable assets				
(a) Less accumulated depletion				
11 Land (net of any amortization)				
12 Intangible assets (amortizable only)		89,488.46		29,028.46
(a) Less accumulated amortization				
13 Other assets (attach schedule)				
14 Total assets		6,961,346.26		6,973,669.30
LIABILITIES AND CAPITAL				
15 Accounts payable		184,985.34		244,794.72
16 Mtges., notes, bonds payable in less than 1 yr.		367,742.00		1,732.24
17 Other current liabilities (attach schedule)		132,006.61		204,971.63
18 Loans from stockholders				
19 Mtges., notes, bonds payable in 1 yr. or more				
20 Other liabilities (attach schedule) DEFERRED FEDERAL INCOME TAXES		2,214,432.00		1,437,020.00
21 Capital stock: (a) Preferred stock				32,000.00
(b) Common stock	3,144,583.00	3,144,583.00	3,153,422.00	3,153,422.00
22 Paid-in or capital surplus (attach reconciliation)		157,627.42		169,547.94
23 ~~Retained earnings—Appropriated (attach sch.)~~ RESERVE FOR LOSS ON FOOD PLANT		28,000.00		
24 Retained earnings—Unappropriated		1,006,249.31		2,093,524.40
25 Less cost of treasury stock		(377,274.81)		(450,240.43)
26 Total liabilities and capital		6,961,346.26		6,973,669.30

5. OTHER CURRENT ASSETS

PREPAID INSURANCE	527838	207186
PREPAID FARM EXPENSES	462519	354321
MILL SUPPLIES	697188	822163
OTHER PREPAID EXPENSES	122099	236827
	181113.44	1278127

17. OTHER CURRENT LIABILITIES

ACCRUED WAGES	159752	332203
ACCRUED TAXES	761586	770793
ACCRUED INTEREST	317524	218639
OTHER ACCRUALS	9032	197200
FEDERAL AND STATE INCOME TAX		526170
	1332266	2049963

NATIONAL RECORD DEVELOPMENT AND MILLING COMPANY
(NY-0374827)

INCOME TAX RETURN - YEAR ENDED APRIL 30, 1967

RECONCILIATION OF CAPITAL STOCK AND PAID IN SURPLUS ACCOUNTS

	Common Stock	Paid-In Surplus
BALANCE, APRIL 30, 1966	3146583 00	157627 46
RECEIPTS FROM SALE OF STOCK BY EXERCISE OF EMPLOYEE STOCK OPTIONS		
PAR VALUE	5700 00	
EXCESS CASH RECEIVED OVER PAR VALUE		9262 50
RECEIPTS FROM SALE OF STOCK BY EXERCISE OF WARRANTS		
PAR VALUE	1125 00	
EXCESS CASH RECEIVED OVER PAR VALUE		2625 00
BALANCE, APRIL 30, 1967	3153408 00	169514 96

FORM **4136**

U. S. Treasury Department
Internal Revenue Service

Computation of Credit for Federal Tax on Gasoline and Lubricating Oil

Attach this form to your income tax return for calendar year 1966
or other taxable year beginning MAY 1, 1966, ending APRIL 30, 1967.

1966

Name (as shown on page 1 of your tax return)
NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY

Address (number and street or rural route)
CLOVERLEAF BUILDING 6811 W. 63RD STREET

City, town or post office, and State
OVERLAND PARK, KANSAS ZIP code 66201

Type of Use	Gasoline: Number of Gallons Used (A)	Gasoline: Rate of Tax (B)	Gasoline: Column (A) Multiplied by Column (B) (C)	Lubricating Oil: Number of Gallons Used (D)	Lubricating Oil: Rate of Tax (E)	Lubricating Oil: Column (D) Multiplied by Column (E) (F)
1 Nonhighway:						
a. Farms	59,624	.04	$2,384.96	10,728	.06	$643.68
b. Motorboat		.02			.06	
c. Aviation	33,863	.02	677.26	160	.06	9.60
d. Other (specify)		.02			.06	
2 Local transit systems*		.02				
3 Totals			$3,062.22			$653.28
4 Total credit claimed (sum of line 3, columns (C) and (F))						$3,715.50

*Attach a statement with the information required under section 6421 of the Internal Revenue Code and Regulations thereunder. List qualifying "lubricating oil" (see Instruction E) in line 1d column D.

INSTRUCTIONS

A. Who May File.—Any individual, estate, trust, or corporation, including a small business corporation, claiming credit for Federal excise tax on the number of gallons of gasoline and lubricating oil used must file and attach this form to the income tax return. Partnerships are not required to file this form because the credit for Federal excise tax on gasoline and lubricating oil used is claimed by the partners. However, partnerships must attach a statement to their returns, Form 1065, showing the allocation of the number of gallons used of gasoline and lubricating oil to the partners by the type of use as shown above.

Special refund provisions are available, if the credit for any of the first three quarters of your taxable year amounts to $1,000 or more (see Instruction D).

B. Period Covered:

(1) *Calendar Year Taxpayers.*—Enter in the appropriate line the number of gallons of gasoline used after June 30, 1965, and before January 1, 1967, and the number of gallons of lubricating oil used after December 31, 1965, and before January 1, 1967.

(2) *Fiscal Year Taxpayers.*—For years beginning after January 1, 1966, and before July 1, 1966, enter the number of gallons of gasoline used after June 30, 1965, through the end of your taxable year; for taxable years beginning on or after July 1, 1966, enter the number of gallons of gasoline used during your taxable year.

For years beginning after January 1, 1966, enter the number of gallons of lubricating oil used after December 31, 1965, through the end of your taxable year.

C. Must Be Timely Filed For Credit on Income Tax Return.—No credit will be allowed on Form 4136 unless claimed on a timely filed income tax return (including any extension).

D. Quarterly Tax Refund of $1,000 or More.—For any of the first three quarters of your taxable year, a claim, Form 843, may be filed for: (a) refund of tax of $1,000 or more for gasoline used (except for farmers), or (b) refund of tax of $1,000 or more for lubricating oil used. However, no claim will be allowed unless filed on or before the last day of the following quarter. A claim for both gasoline and lubricating oil should provide separate computations following the format as shown above.

E. What Lubricating Oil To Include.—A credit may be claimed for lubricating oil (other than cutting oils and other than oil which has previously been used) which is used otherwise than in a highway motor vehicle. Cutting oils are those oils which are sold for use in cutting and machining operation (including forging, drawing, rolling, shearing, punching, and stamping) on metals. Examples of uses of lubricating oil otherwise than in a highway motor vehicle are oiling plant machinery and lubricating vehicles other than highway motor vehicles, such as bulldozers, power shovels, farm tractors, etc.

Do not include oil: (a) used in a highway motor vehicle, such as a truck, even if it is operated off the highway, (b) sold free of the Federal excise tax on lubricating oil, such

650—16—79430-3

Schedule I—SPECIAL DEDUCTIONS

1 (a) 85 percent of line 1, Schedule C	
(b) 60.208 percent of line 2, Schedule C	
(c) 85 percent of line 3, Schedule C	
2 Total (not to exceed 85 percent of [line 28, page 1, less the sum of lines 3 and 5 of this schedule]). (The 85 percent limitation does not apply to a year in which a net operating loss occurs.)	
3 100 percent of line 7, Schedule C	
4 Dividends paid on certain preferred stock of public utilities (see instructions in case of net operating loss)	
5 Western Hemisphere trade corporations (not allowable in year of net operating loss)	
6 Total special deductions—Add lines 2 through 5. Enter here and on line 29(b), page 1	

Schedule J—TAX COMPUTATION

1 Taxable income (line 30, page 1)		124,499.80
2 Surtax exemption (line 1, $25,000, or amount apportioned under section 1561, whichever is lesser)		25,000.00
3 Line 1 less line 2		99,499.80
4 (a) 22 percent of line 1	27,389.96	
(b) 26 percent of line 3	25,869.95	
(c) If multiple surtax exemption is elected under section 1562, enter 6 percent of line 2		53,259.91
5 Income tax (line 4, or line 26 of separate Schedule D, whichever is lesser)		53,259.91
6 Foreign tax credit (attach Form 1118)		
7 Line 5 less line 6		53,259.91
8 Investment credit (attach Form 3468)		18,277.93
9 Line 7 less line 8		34,981.98
10 Tax under section 541 of the Internal Revenue Code (attach Schedule 1120 PH)		
11 Tax from recomputing prior year investment credit (attach computation)		
12 Total tax—Add lines 9, 10, and 11. Enter here and on line 31, page 1		34981.98

H Date incorporated MAY 4 1946

I (1) Did the corporation at the end of the taxable year own directly or indirectly 50 percent or more of the voting stock of a domestic corporation? Yes ☐ No ☒

(2) Did any corporation, individual, partnership, trust, or association at the end of the taxable year own directly or indirectly 50 percent or more of the corporation's voting stock? Yes ☐ No ☒ (For rules of attribution, see section 267(c).)

If the answer to (1) or (2) is "Yes," attach a schedule showing:
(a) name, address, and identifying number; and
(b) percentage owned.

If the answer to (1) above is "Yes," include the taxable income (or loss) of such corporation for the taxable year ending with or within your taxable year.

J Did you have any contracts or subcontracts subject to the Renegotiation Act of 1951? Yes ☐ No ☒

If "Yes," see inst. K. Enter amount here

K Did you at any time during the year own directly or indirectly any stock of a foreign corporation? Yes ☐ No ☒

If "Yes," attach statement required by instruction N.

L Amount of taxable income (or loss) for 4/30 1965 $ 1,150,678.00
4/30 1966 $ (936,425.00) 4/30 1967 $ 229,792.25

M Did you claim a deduction for expenses connected with:

(1) A hunting lodge ☐, working ranch or farm ☐, fishing camp ☐, resort property ☐, pleasure boat or yacht ☐, or other similar facility ☐? (Other than where the operation of the facility was the principal business.) Yes ☐ No ☒

(2) The leasing, renting, or ownership of a hotel room or suite ☐, apartment ☐, or other dwelling ☐, which was used by customers or employees or members of their families? (Other than use by employees while in business travel status.) Yes ☐ No ☒

(3) The attendance of your employees' families at conventions or business meetings? Yes ☐ No ☒

(4) Vacations for employees or members of their families? (Other than amount reported on Form W-2.) Yes ☐ No ☒

N Refer to page 7 of instructions and state the:

Principal business activity MANUFACTURE AND SALE OF ALFALFA MEAL

Principal product or service ALFALFA MEAL

O Were you a member of a controlled group subject to the provisions of section 1561? Yes ☐ No ☒, or section 1562? Yes ☐ No ☒

If "Yes," check type of relationship:
(1) parent-subsidiary ☐
(2) brother-sister ☐
(3) combination of (1) and (2) ☐ (see section 1563)

P Were you liable for filing Forms 1096 and 1099 or 1087 for the calendar year 1966? Yes ☒ No ☐

If "Yes," where were they filed? ST. LOUIS, MISSOURI

Q Did you make distributions during the taxable year:

(1) that are not considered wholly taxable as dividends to shareholders because of insufficient earnings and profits, or (2) in a section 333 liquidation where shareholders are taxed on their pro rata share of earnings and profits? Yes ☐ No ☒ (See sections 316, 301, and 333.) If this is a consolidated return, answer here for the parent corporation and on Form 851, Affiliations Schedule, for each subsidiary.

R Was there any substantial change in the manner of determining quantities, costs, or valuations between opening and closing inventory? Yes ☐ No ☒ If "Yes," attach explanation.

S Were you a U.S. shareholder of any controlled foreign corporation? Yes ☐ No ☒. (See sections 951 and 957.) If "Yes," attach Form 3646 for each such corporation.

Schedule L—BALANCE SHEETS

ASSETS	Beginning of taxable year (A) Amount	Beginning of taxable year (B) Total	End of taxable year (C) Amount	End of taxable year (D) Total
1 Cash				
2 Trade notes and accounts receivable			389796.22	
(a) Less allowance for bad debts			30000.00	
3 Inventories				
4 Gov't obligations: (a) U.S. and instrumentalities		563545.60		643262.05
(b) State, subdivisions thereof, etc.				
5 Other current assets (attach schedule)				
6 Loans to stockholders				
7 Mortgage and real estate loans				
8 Other investments (attach schedule)				
9 Buildings and other fixed depreciable assets			10230805.83	
(a) Less accumulated depreciation			5580742.93	
10 Depletable assets				
(a) Less accumulated depletion				
11 Land (net of any amortization)		SCHEDULE ATTACHED		
12 Intangible assets (amortizable only)				
(a) Less accumulated amortization				
13 Other assets (attach schedule)				
14 Total assets				6915661.36
LIABILITIES AND CAPITAL				
15 Accounts payable				
16 Mtges., notes, bonds payable in less than 1 yr.				
17 Other current liabilities (attach schedule)				
18 Loans from stockholders				
19 Mtges., notes, bonds payable in 1 yr. or more				
20 Other liabilities (attach schedule)				
21 Capital stock: (a) Preferred stock				
(b) Common stock		2869308.19		2701044.58
22 Paid-in or capital surplus (attach reconciliation)		157627.46		169514.96
23 Retained earnings—Appropriated (attach sch.)				
24 Retained earnings—Unappropriated		1006249.31		2093524.40
25 Less cost of treasury stock		( )		( )
26 Total liabilities and capital				

Schedule M-1—RECONCILIATION OF INCOME PER BOOKS WITH INCOME PER RETURN

1 Net income per books	1087275.09	7 Income recorded on books this year not included in this return (itemize)	
2 Federal income tax	74538.68	(a) Nontaxable interest $	
3 Excess of capital losses over capital gains		DECREASE IN RESERVE FOR LOSS ON DISPOSITION OF TRK. RENT EQUIPMENT	28003.00
4 Taxable income not recorded on books this year (itemize)		8 Deductions in this tax return not charged against book income this year (itemize)	
		(a) Depreciation $	
5 Expenses recorded on books this year not deducted in this return (itemize)		(b) Depletion $	
(a) Depreciation $			
(b) Depletion $		SCHEDULE ATTACHED	223994.22
		9 Total of lines 7 and 8	251994.22
ACCRUED RENT EXPENSE	15000.00	10 Income (line 28, page 1)—line 6 less 9	924819.55
6 Total of lines 1 through 5	1176813.77		

Schedule M-2—ANALYSIS OF UNAPPROPRIATED RETAINED EARNINGS PER BOOKS (line 24, page 4)

1 Balance at beginning of year	1006249.31	5 Distributions: (a) Cash	
2 Net income per books	1087275.09	(b) Stock	
3 Other increases (itemize)		(c) Property	
		6 Other decreases (itemize)	
4 Total of lines 1, 2, and 3	2093524.40	7 Total of lines 5 and 6	
		8 Balance at end of year (line 4 less 7)	2093524.40

Schedule L—BALANCE SHEETS

ASSETS	Beginning of taxable year (A) Amount	Beginning of taxable year (B) Total	End of taxable year (C) Amount	End of taxable year (D) Total
1 Cash			389796.22	
2 Trade notes and accounts receivable			30000.00	
(a) Less allowance for bad debts				
3 Inventories		563545.60		643262.05
4 Gov't obligations: (a) U.S. and instrumentalities				
(b) State, subdivisions thereof, etc.				
5 Other current assets (attach schedule)				
6 Loans to stockholders				
7 Mortgage and real estate loans				
8 Other investments (attach schedule)				
9 Buildings and other fixed depreciable assets			10230805.83	
(a) Less accumulated depreciation			5580742.93	
10 Depletable assets				
(a) Less accumulated depletion		SCHEDULE		
11 Land (net of any amortization)		ATTACHED		
12 Intangible assets (amortizable only)				
(a) Less accumulated amortization				
13 Other assets (attach schedule)				691566.36
14 Total assets				
LIABILITIES AND CAPITAL				
15 Accounts payable				
16 Mtges., notes, bonds payable in less than 1 yr.				
17 Other current liabilities (attach schedule)				
18 Loans from stockholders				
19 Mtges., notes, bonds payable in 1 yr. or more				
20 Other liabilities (attach schedule)				
21 Capital stock: (a) Preferred stock		2869308.19		2701044.58
(b) Common stock		157627.46		169514.96
22 Paid-in or capital surplus (attach reconciliation)				
23 Retained earnings—Appropriated (attach sch.)				
24 Retained earnings—Unappropriated		1006249.31		2093524.40
25 Less cost of treasury stock		( )		( )
26 Total liabilities and capital				

Schedule M-1—RECONCILIATION OF INCOME PER BOOKS WITH INCOME PER RETURN

1 Net income per books	1087275.09	7 Income recorded on books this year not included in this return (itemize)	
2 Federal income tax	74538.68	(a) Nontaxable Interest $	
3 Excess of capital losses over capital gains		DECREASE IN RESERVE FOR LOSS ON DISPOSITION OF DEPT. FOR REPLACEMENT	28000.00
4 Taxable income not recorded on books this year (itemize)		8 Deductions in this tax return not charged against book income this year (itemize)	
5 Expenses recorded on books this year not deducted in this return (itemize)		(a) Depreciation $	
(a) Depreciation $		(b) Depletion $	
(b) Depletion $		SCHEDULE ATTACHED	223994.22
ACCRUED RENT EXPENSE	15000.00	9 Total of lines 7 and 8	251994.22
6 Total of lines 1 through 5	1176813.77	10 Income (line 28, page 1)—line 6 less 9	924819.55

Schedule M-2—ANALYSIS OF UNAPPROPRIATED RETAINED EARNINGS PER BOOKS (line 24, page 4)

1 Balance at beginning of year	1006249.31	5 Distributions: (a) Cash	
2 Net income per books	1087275.09	(b) Stock	
3 Other increases (itemize)		(c) Property	
		6 Other decreases (itemize)	
		7 Total of lines 5 and 6	
4 Total of lines 1, 2, and 3	2093524.40	8 Balance at end of year (line 4 less 7)	2093524.40

STIPULATION EXHIBIT 11

Minutes of Directors Meeting, April 8, 1957.

MINUTES OF ADJOURNED QUARTERLY MEETING OF THE BOARD OF DIRECTORS OF NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY

April 8, 1957.

The regular quarterly meeting of the Board of Directors of National Alfalfa Dehydrating and Milling Company reconvened at the Peabody Hotel in Memphis, Tennessee on Monday, April 8, 1957 at 9:00 A.M., pursuant to call and notice.

The following directors were present:

John F. Connelly
James J. Davis
Robert W. Drummond
Henry A. Hofmann
R. E. Nye
Frank N. Piasecki
John R. Porter
Louis Silverstein
Cyril C. Slapnicka
Edgar M. Tutwiler

constituting a majority of the Board.

Directors absent:

C. M. Saunders
Carl M. Shinn
Gus Wolfe

In addition to the directors, L. R. Pollock, Secretary of the Company, was present: also upon invitation W. J. Small, A. R. McFadden, Vice-President in charge of Sales and Dr. J. R. Couch of Texas A & M College.

The meeting was called to order by John R. Porter, Chairman of the Board, who presided over the meeting. L. R. Pollock, Secretary of the Company acted as Secretary of the meeting.

The chairman stated that the first order of business would be the reading of the minutes of the last meeting of the directors. Inasmuch as each of the directors had been furnished, in ad-

vance of the meeting, with a copy of the minutes of the last meeting of the Board, held February 8, 1957, and was familiar with the proceedings therof, and offered no suggestions or corrections thereto, it was moved by Edgar M. Tutwiler that the reading of the minutes be dispensed with and that they be approved as recorded, which motion was seconded by James J. Davis and carried.

At the request of the President, A. R. McFadden reviewed the benefits which have accrued to this company following the program adopted of producing and advertising to the trade a high quality product for which our customers are willing to pay a nice premium over that received for standard 17%, 100,000 A meal. Mr. McFadden outlined plans for improving still further the quality of our production, particularly a 20% meal for inclusion in broiler rations.

Following the above discussion Mr. McFadden introduced Dr. J. R. Couch now employed by this Company on a retainer basis as nutritionist.

Dr. Couch discussed the specialization taking place in all phases of livestock feeding. The commercial dairyman, commercial swine grower, broiler factories and commercial egg producers were producing so efficiently today on modern feeds that the diversified feeding on farms was virtually a thing of the past.

He pointed out that the 6½ to 7 pounds of feed required to produce a 3½ pound broiler over a sixteen week period as compared to 2½ pounds of feed today to produce a broiler equal in weight in nine weeks. Such advances in poultry nutrition have been brought about through the use of antibiotics, improved ingredients and scientific formulation.

He further pointed out that the first work done on high energy feeds was in 1947–48 by Dr. E. P. Singsen of the University of Connecticut, using a high corn ratio up to 60%, which induced into the ration a high level of fat. The energy content of feed is directly related to the fat content; thus, the addition of animal fats has been a new development within the past three to four years. It was Dr. Couch's feeling that National Alfalfa was the only firm in the dehydrating industry with a progressive look toward product improvement. He feels that our 20% fibre product is only a stepping stone to greater improvements which will, no doubt, be brought about within the next year's passing and that we shall try to develop a product

down in the 12–14% total fibre range. He believes these products could be sold at a 5–6¢ per pound price with good market acceptance.

The need for dehydrated alfalfa meal of higher quality is also well established for pigmentation purposes and he made the remark that during a recent conference, the question most often asked of him was "how do we get adequate pigmentation?" He pointed out that many feed firms were using corn gluten meal as a pigmentation factor and paying high prices for it. In the Southwestern states, where they are using an all-white ration; that is, consisting of milo or white corn, that the pigmentation was a very definite problem with them. And our product should have much appeal since it is now the only product providing Xanthophyll in appreciable quantities. Inasmuch as our business is getting more technical, Dr. Couch was agreeable to working with us on some special brochures covering specific feed applications. Mr. Frank Piasecki asked if the energy of dehydrated alfalfa was measured in terms of calories and the response from Dr. Couch was in the affirmative.

Copies of the Profit and Loss Statements for the months of March 1956 and 1957 and for the eleven months periods ended March 31, 1956 and 1957, and the Comparative Balance Sheets as of March 31, 1956 and 1957 were distributed. The Comparative Profit and Loss Statements reflected a net operating profit of $107,377.18 for the month of March 1957 as compared to a loss of $5,476.25 for the same month in 1956; also a net operating profit of $388,557.72 for the eleven months ended March 31, 1957 as compared to a loss of $381,217.71 for the eleven months of the preceding year. The indebtedness of the Company to the Banks providing working capital has been entirely retired, whereas a year ago there still remained unpaid $1,708,000.00. As of March 31, 1957 the inventories of meal in storage have been reduced to 17,354 tons carried at an average price of $44.47 per ton, whereas on March 31, 1956 there were 48,371 tons in storage carried at $46.20 per ton.

In discussing the financing program of the Company for the ensuing season Mr. Hofmann stated that he had approached several of the banks which had participated in the credit line extended for providing working capital funds last year. He estimated that we will require $3,500,000.00 this year. It appears that several of the banks heretofore participating prefer to retire from the program, however, it is thought that they will go

along another year. It is also probable that certain banking interests in Toledo and Memphis will join in the line. Final arrangements cannot be made until an audited statement disclosing the results of the current year operations are available for the banks inspection. In the meantime some arrangement for intermediate financing must be considered.

The Chairman then called for a report of the Executive Committee relative to the progress which had been made in formulating a plan of reorganization to include the retirement of the outstanding 5% Cumulative Preferred Stock of the Company and forgiveness or cancellation of accumulated delinquent Preferred Stock dividends.

Speaking for the Committee Robert W. Drummond gave a detailed report of the program developed in conference with W. J. Small and which is being submitted to the Board for its consideration and action before being submitted to the vote of the stockholders of the Company. In brief the proposed plan would require the Preferred Stockholders to surrender their stock and receive in exchange 5% debenture bonds of the Company on the basis of one share of preferred stock for one $50.00, 5% debenture bond, due July 1, 1975. In addition the plan includes an increase in the indebtedness of the Company by $2,352,950.00 to provide for an issue of debentures in like amount to holders of 5% preferred stock for preferred stock surrendered in exchange for said debentures; changing the par value of the Common Stock of the Company from $1.00 to $3.00 per share and amending the certificate of Incorporation to reflect the foregoing changes. The plan further provides in lieu of preferred stock dividend arrears accumulated on said Preferred Stock, which as of July 1, 1957 will amount to $10.00 per share, the Preferred Stockholders would receive for each share of Preferred Stock held one warrant evidencing their right to subscribe to one-half share of Common Stock of the Company at a price of $10.00 per share.

After full discussion and careful consideration the following resolution was introduced by Louis Silverstein, who moved its adoption, which motion was seconded by John F. Connelly and unanimously carried:

RESOLUTION

RESOLVED, that the officers of the Company, be and they are hereby authorized to effectuate a reorganization of the Company by way of recapitalization, and

RESOLVED, that the President or Vice-President and the Secretary or Assistant Secretary of the Company be and they are hereby authorized to enter into a trust indenture with Fidelity-Philadelphia Trust Company of Philadelphia, Pennsylvania, dated, as of July 1, 1957, pursuant to the terms of which there shall be issued $2,352,950.00 principal amount 5% Debentures, due July 1, 1975, which said bonds shall be issued in exchange for shares of the 5% Cumulative Preferred Stock on the basis of $50.00 principal amount of such debentures for each share of preferred stock and that this resolution, when ratified by the shareholders shall constitute authority for said issue, and

RESOLVED, that the Company be authorized to issue warrants for the purchase of the common stock of the Company to each preferred shareholder participating in the exchange of his preferred stock for Debentures of the Company in the reorganization effective August 1, 1957, on the basis of one warrant for each share of Preferred Stock surrendered, said warrants to evidence the right to purchase one-half (½) share of common stock and said warrants to be exercisable to purchase only full shares of common stock of the Company at a price of $10.00 per share at any time from the date of issue until July 1, 1969 or so long as any debenture bonds remain outstanding, after which date warrants will become void, and

RESOLVED, that the Company increase the par value of its shares from $1.00 to $3.00 and that the amount $1,580,000.00 be transferred from Paid-In-Capital to the Capital Account in order to effectuate this resolution and reflect the increase in par value of the Common Stock, and

RESOLVED, that the Articles of Incorporation of the Company be amended by changing Article FOURTH to read as follows:

"The total number of shares of stock which the Corporation will have authority to issue is 1,000,000 shares of Common Stock of the par value of $3.00 per share.

The minimum amount of capital with which the Corporation will commence business will be $1,000.00."

1. Each share of Common Stock shall be entitled to one vote per share in any matter requiring a vote of shareholders and each share shall be entitled to, upon any liquidation, dissolution, or winding up of the affairs of the Corporation, whether voluntary or involuntary, to participate pro-rata in the assets available for distribution.

2. No holder of shares of stock of the Corporation shall be entitled, as such, to subscribe to or purchase any additional shares of stock, whether now or hereafter authorized, or obligations convertible into any class or classes of stock, or shares of stock of any class convertible into any class or classes, or obligations, shares of stock or other securities carrying warrants or rights to subscribe to shares of stock of the Corporation of any class or classes, in any case whether now or hereafter authorized, but any and all shares of stocks, bonds, debentures or other securities or obligations, whether or not convertible into stock or carrying warrants or rights entitling the holders thereof to subscribe to stock may be issued, sold or disposed of from time to time by the Board of Directors to such persons, firms or corporations and for such consideration, so far as may be permitted by law, as it shall from time to time in its absolute discretion determine, without offering the same to the holders of shares of stock of the Corporation or any class then outstanding.

3. The Company shall be entitled to issue warrants for the purchase of common stock on such terms as the Board of Directors may determine but such warrants when issued shall be binding on future actions of the Board of Directors and the terms thereof shall not be altered, amended or repealed without the consent of such warrant holders, AND

RESOLVED, that this resolution and the reorganization and recapitalization contemplated hereby be submitted to a vote of the shareholders, and if adopted by the requisite number of shareholders, all rights and privileges of the 5% Cumulative Preferred Shares heretofore expressed or inherent in the ownership of said Preferred Stock shall cease and determine as of August 1, 1957 except such right to surrender the said shares of stock

on the terms herein contained except as otherwise provided by law, and

RESOLVED, that the officers of the Company be hereby authorized to submit the Plan of Reorganization to the Commissioner of Internal Revenue in an attempt to have the said Plan qualified as a tax free reorganization under the Internal Revenue Code of 1954, and

RESOLVED, that the officers of the Company be hereby authorized to incur any and all necessary expenses to effectuate the Plan of Reorganization approved and adopted by this meeting of the Board of Directors.

The Secretary reported that the Committee, heretofore appointed to negotiate the sale of plants with substandard earnings or non-productive properties, at the best prices obtainable, had concluded the sale of 23 small labor houses and buildings located at Bristol, Wilson Junction, McClave, Wiley, Fort Lyon, King Center, May Valley and Melina, including small tracts of land on which adobe or stucco buildings, which could not be moved, were located; also that negotiations were pending for sale of other buildings of like nature. Inasmuch as the amount involved in each instance is small it was the consensus of the Board that blanket approval be given covering the action of the officers and agents of the Company in agreeing to and concluding the sale of such properties and that the sales be, in all respects, ratified, approved and confirmed.

The Secretary presented the request of the Department of Highways in Alexander County, Illinois for a right-of-way grant for public highways across the south side of that tract of land in the NE¼ of the NE¼ of the NE¼ of Section 10, Township 14 South, Range 3 West of the 3rd Principal Meredian purchased by this Company from Western Alfalfa Meal Company March 31, 1956, said grant containing approximately 0.02 acres more or less. After due consideration the following resolution was introduced and on motion made, seconded and carried, was adopted:

RESOLUTION

RESOLVED, that the President or any Vice President and the Secretary or any Assistant Secretary or other proper officers of the Company are hereby authorized and directed to execute and deliver a right-of-way grant or easement to the People of the State of Illinois for

a public highway across the following described par
of land in Alexander County, Illinois, to-wit:

'All that part of the following described tract of grou
lying southeasterly of a line situated 40 feet dist
northwesterly from and parallel to the centerline
Forest Highway No. 13, containing 0.02 acres more
less, to-wit:

All that part of the N½ of the NE¼ of the NE
of Section 10, Township 14 South, Range 3 West of t
3rd P. M. which was originally platted in Block 2 a
Railroad Street of Throckmorton's First Subdivisio
near or in McClure, Alexander County, Illinois, as sho
by the plat thereof recorded in Book E. of plats, page
in the office of the Recorder of Alexander County a
later replatted by Ira Hastings and Nettie Hastin
as shown by the plat thereof recorded in Book E
Plats, page 66, in the office of said Recorder, except
parcel of ground in the southwesterly corner there
50 feet wide in an easterly and westerly direction a
180 feet long in a northerly and southerly directio
containing about .205 acres, more or less, conveyed
Warren Samuel Hastings and Ruby Earlean Hastin
his wife and Ira Vernon Hastings, a bachelor, to Willi
A. Abernathie by Warranty Deed, dated March 10, 193
and recorded March 12, 1936 in Book 14 of Deeds, pa
448, in the office of said Recorder, including an eas
ment on the strip of land 10 feet wide in an easterly a
westerly direction, 180 feet long in a northerly a
Southerly direction, lying on the east side and adjoi
ing the parcel of ground conveyed to William A. Ab
nathy.

The request of The First National City Bank of New Yo
Transfer Agent for the Company, for a resolution authorizi
that Bank, as Transfer Agent, to issue and cause to be reg
tered by the City Farmers Trust Company, as Registrar,
replacement certificate in lieu of Certificate No. NLO 3642
65 shares of the 5% Cumulative Preferred $50.00 par val
stock, registered in the name of Helen R. White, reported lo
with which request a counterpart of "Affidavit of Loss a
Ownership" and "Indemnity Bond" executed by the Mas
chusetts Bonding and Insurance Company assuming liabil
thereunder, was submitted. After consideration the followi

resolution was introduced and on motion made, seconded and carried, was adopted:

RESOLUTION

WHEREAS, Section 5 of Article V of the By-Laws of this Company provides that the Board of Directors may direct a new certificate or certificates to be issued in place of any ———— certificates theretofore issued by the corporation alleged to have been lost or destroyed, upon making an affidavit of the fact by the person claiming the certificate to be lost, and the Board of Directors may, in its discretion in such case, require the owner of such lost or destroyed certificate or certificates, or his legal representative to advertise the same and/or to give bond in such amount as it may direct as indemnity against any claim that may be made against the corporation, and

WHEREAS, there has now been supplied to the First National City Bank of New York, New York, Transfer Agent of the Company, an affidavit of Helen Rice White, certifying that certificate No. NLO 3642 for 65 shares of 5% Cumulative Preferred $50.00 Par Value Stock, registered in the name of Helen R. White, was received in the spring of 1956 and temporarily placed with other correspondence on dresser top. Deponent further certifies that in cleaning, another member of the family emptied a wastebasket next to the dresser, into which the certificate had fallen. The waste material was burned, including the certificate. The loss was discovered the next day by deponent. A diligent household search failed to reveal the certificate, and

WHEREAS, the Massachusetts Bonding and Insurance Company has assumed liability under Lost Security Blanket Bond No. J632052 to indemnify this Company and save it harmless from any loss of every nature whatsoever arising from and out of the issuance by this Company of a replacement certificate in the name of Helen R. White to evidence said 65 shares of 5% Cumulative Preferred Stock, and

WHEREAS, the said Transfer Agent has supplied copies of said affidavit of Helen Rice White and bond of Massachusetts Bonding and Insurance Company assuming lia-

bility and acceptance of this risk which have been presented to this Company, and

WHEREAS, By reason of the foregoing, it is not deemed necessary by the Board to require the owner of the lost certificate aforesaid to advertise the same in view of said affidavit and indemnity bond protecting this Company.

NOW THEREFORE, BE IT RESOLVED, that the aforesaid affidavit and indemnity bond in favor of this Company, executed by Massachusetts Bonding and Insurance Company, counterparts of which were presented to this meeting, be and the same are approved by this Company;

That the First National City Bank of New York, New York Transfer Agent of this Company, be and it hereby is authorized and directed to issue and countersign as Transfer Agent and deliver to the City Bank Farmers Trust Company of New York, Registrar of this Company, a replacement certificate registered in the name of Helen R. White to stand in lieu of the above certificate reported lost;

That the City Bank Farmers Trust Company, New York, Registrar of this Company, be and it hereby is authorized to countersign as Registrar the said replacement certificate authorized and directed to be issued in this resolution;

That as and when said replacement certificate has been duly issued and countersigned by said Transfer Agent and Registrar of this Company, that proper steps be taken by said Transfer and/or Registrar to deliver said certificate to Helen Rice White.

The attention of the Board was directed to the losses sustained at Wiley, Colorado as a result of an extremely violent windstorm on Wednesday afternoon, March 13, 1957. Hay sheds Numbers 3 and 5 were completely demolished, Warehouse No. 1 was seriously damaged and warehouse No. 2 and the Office Building to a lesser degree. Claim in the amount of $16,425.04 has been made to cover these losses as follows:

Hay Shed No. 3	$7,100.00
Hay Shed No. 5	7,000.00
Warehouse No. 1	1,568.70
Warehouse No. 2	245.00
Office Building	511.34
	$16,425.04

The attention of the Board was directed to the matter of carrying life insurance on the life of the President of the Company to compensate the Company for the loss of services in event of the President's death. Several plans, which had been submitted by the Continental Assurance Agency in Philadelphia were given consideration. It was the consensus of the Board that it is for the best interests of the Company that life insurance be carried on the life of the President at the Company's expense with the Company to be named the beneficiary. Thereupon the following resolution was introduced and on motion, made, seconded and carried, was adopted:

RESOLUTION

RESOLVED that the proper officers of this company be and they hereby are authorized, empowered and directed to enter into and complete negotiations with such life insurance company or companies as in their discretion is for the best interest of the Company for life insurance coverage on the life of Henry A. Hofmann, President of this Company, in the principal amount of $500,000.00 with the Company named as beneficiary thereunder, and

BE IT FURTHER RESOLVED, that the officers of this Company be and they hereby are authorized and directed to do any and all things necessary or desirable to carry out the provisions of this resolution.

In connection with matters incident to the Annual Meeting of the Stockholders the Secretary stated that the names of persons to be inserted as proxies in the Notice of Meeting should be selected and approved by the Board; also that the date for the determination of the stockholders entitled to vote at the Annual Meeting to be held July 23, 1957, should be fixed by the Board, whereupon the following resolution was introduced and, on motion made, seconded and carried, was adopted:

RESOLUTION

WHEREAS, in order to assist in securing a quorum at the Annual Meeting of the Stockholders to be held July 23, 1957, it is deemed advisable for the Company to solicit proxies and to designate a Proxy Committee or Committees.

NOW THEREFORE, BE IT RESOLVED, that John R. Porter, Robert W. Drummond and Edgar M. Tutwiler be and each hereby is designated as one of the proxies to be so named as a member of such Proxy Committee to represent the Common Stockholders, and

BE IT FURTHER RESOLVED, that W. J. Small, Gus Wolfe and R. E. Nye be and each hereby is designated as one of the proxies to be so named as a member of such Proxy Committee to represent the 5% Cumulative Preferred Stockholders, and

WHEREAS, in lieu of closing the stock transfer books for the determination of the stockholders entitled to vote at the Annual Meeting to be held July 23, 1957 or any adjournment thereof it is deemed preferable to fix a date for such determination,

NOW, THEREFORE, BE IT FURTHER RESOLVED, that the stock transfer books will not be closed but that June 21, 1957 be and hereby is fixed as the date for the determination of the stockholders entitled to vote at the Annual Meeting of the stockholders to be held July 23, 1957.

The attention of the Board was then directed to the form of notice of Annual Stockholders Meeting and to the information to be included in the Proxy and Proxy Statement, which must be filed with the Securities and Exchange Commission ten days before the mailing to the stockholders in connection with the solicitation of proxies by the Management to be used at the Annual Meeting of the Stockholders for the election of Directors and the transaction of such other business as may properly come before the meeting. It was pointed out that the names of such persons for whom the proxies were to be voted as Directors together with pertinent information, including principal occupations, stock ownership, etc., as to each must be shown. Upon motion made, seconded and carried, the following thirteen persons were designated as the persons for whom said proxies were to be voted for the office of Director of the Company for the ensuing fiscal year, and until their successors were duly elected and qualified, to-wit:

To be elected by Common Stockholders

John F. Connelly
James J. Davis
Robert W. Drummond
Edgar M. Tutwiler

Henry A. Hofmann
John R. Porter
Clarence M. Saunders
Louis Silverstein
F. N. Piasecki

To be elected by Preferred Stockholders

R. E. Nye
Carl M. Shinn
Cyril C. Slapnicka
Gus Wolfe

It was the consensus of the Board that the preparation of the President's Annual Message to the Stockholders, to accompany the Notice of Annual Meeting and Financial Report to the Stockholders, be delegated to Messrs. Hofmann, Drummond and Davis.

The attention of the Board was then directed to the quarterly dividend, due and payable on the 5% Cumulative Preferred Stock of the Company on June 1, 1957. In view of the undetermined income tax liability of the Company resulting from the sale of the Garden City gas storage facilities to Grain Elevator Warehouse Company and the proposed recapitalization program to be submitted to vote of the stockholders at the annual meeting no action was taken by the Board.

Inasmuch as all the business of the Company, which would come up for consideration and action at the regular meeting of the Board scheduled to be held Wednesday, June 11, 1957, has been considered and acted upon at this meeting it was the consensus of the Board that said regular meeting of the Board of Directors to be held June 11, 1957 be adjourned to reconvene on the date and at the place to be fixed by vote of the stockholders at the Annual Meeting to be held July 23, 1957 as the organization meeting of the newly elected Board of Directors.

There being no further business to come before the meeting the same was, on motion made, seconded and carried, adjourned.

L. R. Pollock,
Secretary.

STIPULATION EXHIBIT 12

Indenture Dated as of July 1, 1957.

ATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY

and

FIDELITY-PHILADELPHIA TRUST COMPANY

As Trustee

Indenture

Dated as of July 1, 1957

$2,352,950 Eighteen Year 5% Debentures

Due July 1, 1975

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THIS INDENTURE dated as of July 1, 1957, between NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY, a corporation duly organized and existing under the laws of the State of Delaware, party of the first part (hereinafter called the "Company"), and Fidelity-Philadelphia Trust Company, a state bank organized and existing under the laws of the Commonwealth of Pennsylvania, party of the second part (hereinafter called the "Trustee"),

WITNESSETH:

WHEREAS, the Company has duly authorized the issue of its Eighteen Year 5% Debentures, for an aggregate principal amount of $2,352,950; and

WHEREAS, to provide for the authentication and delivery of the Debentures by the Trustee and to establish the terms and conditions upon which the Debentures are to be issued, the Company has duly authorized the execution and delivery of this Indenture; and

WHEREAS, the form of the Debentures, and the form of the Trustee's certificate of authentication to be executed thereon, shall be substantially as follows, with such appropriate insertions, omissions, substitutions and variations as are herein provided or permitted:

[FORM OF DEBENTURE]

No. $

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY

EIGHTEEN YEAR 5% DEBENTURES

DUE JULY 1, 1975

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY (hereinafter called the "Company"), a corporation duly organized and existing under the laws of the State of Delaware, for value received, hereby promises to pay on the 1st day of July, 1975, to ,
the registered holder hereof, at the principal office of the Trustee under the Indenture hereinafter mentioned, in the City of Philadelphia, Pennsylvania, the principal amount of Dollars
($) in lawful money of the United States of America which at

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the time of payment is legal tender for public and private debts, and to pay interest thereon at said office in like lawful money on January 1 and July 1 in each year, at the rate of 5% per annum until said principal amount shall be paid or the payment thereof shall have been duly provided.

This Debenture is one of a duly authorized issue of Debentures of the Company known as its Eighteen Year 5% Debentures (hereinafter called the "Debentures"), limited to the aggregate principal amount of $2,352,950, all issued and to be issued under and pursuant to an Indenture dated as of July 1, 1957, made and entered into between the Company and Fidelity-Philadelphia Trust Company as Trustee, to which Indenture and any indentures supplemental thereto (all hereinafter collectively called the "Indenture") reference is hereby made for a description of the rights, duties and immunities thereunder of the Trustee and the rights and limitations of rights thereunder of the holders of the Debentures of the Company.

The Indenture contains provisions permitting the Company and the Trustee, with the consent of the holders of not less than 66⅔% in aggregate principal amount of the then outstanding Debentures, evidenced as in the Indenture provided, to execute supplemental indentures adding any provisions to or changing in any manner or eliminating any of the provisions of the Indenture; provided, however, that no such supplemental indenture shall (a) reduce the principal amount or extend the fixed maturity of any of the Debentures or reduce the rate or extend the time of payment of interest thereon, without the consent of the holder of each Debenture so affected, or (b) reduce the aforesaid percentage of Debentures, the consent of the holders of which is required to approve any such supplemental indenture, without the consent of the holders of all then outstanding Debentures.

In case a default as defined in the Indenture shall occur and be continuing, the principal of all outstanding Debentures may be declared due and payable before maturity, in the manner, at the time and with the effect provided in the Indenture.

The Indenture provides that the holders of a majority in aggregate principal amount of the then outstanding Debentures may on behalf of the holders of all of the Debentures waive any past default and its consequences, in the manner and to the extent provided in the Indenture. Any

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such waiver by the holder of this Debenture shall be conclusive and binding upon such holder and upon all future holders of this Debenture (unless effectively revoked as provided in the Indenture), irrespective of whether any notation of such waiver is made upon this Debenture.

All or any of the Debentures may be redeemed at any time by the Company at its option on notice given as provided in the Indenture at par plus accrued interest to date of redemption after July 1, 1958.

The Debentures are entitled to the benefit of a contingent sinking fund as provided in the Indenture and, to the extent provided in the Indenture, are severally subject to redemption in principal amounts aggregating not less than $10,000 through the operation of said sinking fund on certain interest payment dates, on notice given as provided in the Indenture, at the sinking fund redemption price of 100% of the principal amount of the Debentures so redeemed, together with accrued interest to the redemption date.

If this Debenture shall be called for redemption and payment hereof duly provided for, this Debenture shall cease to bear interest from and after the redemption date.

This Debenture must be registered as to principal in the holder's name at the principal office of the Trustee in the City of Philadelphia, Pennsylvania, such registration being noted on this Debenture. No service charge shall be made for any such registration or transfer, but the Company may require payment of a sum sufficient to cover any stamp tax or other governmental charge that may be imposed in relation thereto.

The Company and the Trustee may treat the person in whose name this Debenture is registered, as the absolute owner of this Debenture, whether or not this Debenture shall be overdue, for the purpose of receiving payment thereof and for all other purposes, and neither the Company nor the Trustee shall be affected by any notice to the contrary.

No recourse under or upon any obligation, covenant or agreement of the Indenture, or of any Debenture, or because of the creation of any indebtedness evidenced thereby, shall be had against any incorporator, stockholder, officer or director, as such, past, present or future, of the Com-

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pany or of any successor corporation, either directly or through the Company or any successor corporation, whether by virtue of any constitution or statute or rule of law or equity or by the enforcement of any assessment or penalty or otherwise, all such liability being by the acceptance hereof and as part of the consideration for the issue hereof expressly waived and released, as provided in the Indenture.

This Debenture shall not become valid or obligatory for any purpose until the certificate of authentication hereon shall have been executed by the Trustee.

IN WITNESS WHEREOF, NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY has caused this Debenture to be signed by its President or one of its Vice-Presidents by imprinting thereon the facsimile signature of such officer and a facsimile of its corporate seal to be imprinted hereon and attested by the facsimile signature of its Secretary or an Assistant Secretary.

Dated, August 1, 1957.

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY

By_____
President.

Attest:

_____
Secretary.

[FORM OF TRUSTEE'S CERTIFICATE OF AUTHENTICATION]

This is one of the Debentures described in the within mentioned Indenture.

FIDELITY-PHILADELPHIA TRUST COMPANY,
Trustee.

By_____
Authorized Officer.

and

WHEREAS, all things necessary to make the Debentures, when executed by the Company and authenticated by the Trustee and delivered, the valid, binding and legal obligations of the Company, and to constitute these presents a valid Indenture and agreement according to its terms, have been done and performed;

NOW, THEREFORE, in order to declare the terms and conditions on which the Debentures are issued and received, and in consideration of the premises and of the purchase and acceptance of the Debentures by the registered holders thereof, the Company covenants and agrees with the Trustee, for the benefit of the Trustee and for the equal and ratable benefit, security and protection of the registered holders of the Debentures, when delivered as hereinafter provided, without preference of any of the Debentures over one another by reason of priority in the time of issue or otherwise, as follows:

ARTICLE I.

Definitions.

SECTION 1.01. The terms defined in this *Section 1.01* shall for the purposes hereof have the meanings herein specified unless the context otherwise requires, such definitions to be equally applicable to both the singular and plural forms; and, unless otherwise defined herein, all terms used herein which are defined in the Trust Indenture Act of 1939 shall have the meanings assigned to such terms in said Trust Indenture Act:

(a) The term "corporation" shall include a voluntary association, a joint stock company and a business trust.

(b) The term "successor," or "successor corporation," when used with respect to a particular corporation, shall mean the corporation successor to such corporation by consolidation or merger or which shall have acquired or to which shall have been leased the property of such corporation as an entirety or substantially as an entirety.

(c) The term "Company" shall mean the party of the first part hereto, National Alfalfa Dehydrating and Milling Company, and, subject to the provisions of *Article XIII*, shall also include any successor to the Company.

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(d) The term "Subsidiary" shall mean any corporation of which the Company and/or one or more Subsidiaries own more than 50% of the outstanding stock having by its terms ordinary voting power to elect a majority of the board of directors of such corporation, irrespective of whether at the time stock of any other class or classes of such corporation shall have or might have voting power by reason of the happening of any contingency.

(e) The term "Wholly-Owned Subsidiary" shall mean any Subsidiary all the shares of capital stock of which (other than qualifying shares required to be owned by directors under any applicable law) shall at the time be owned by the Company and/or one or more other Wholly-Owned Subsidiaries.

(f) The term "Independent Public Accountants" shall mean any firm of certified public accountants of recognized standing, selected or approved by the Board of Directors of the Company or chosen by the shareholders of the Company and satisfactory to the Trustee, and which is in fact independent.

(g) The term "Balance Sheet" shall mean a balance sheet reflecting the accounts of the Company not consolidated with those of its Subsidiaries and prepared in accordance with generally accepted principles of accounting provided, however, that the investments of the Company in the capital stock of its Subsidiaries may be stated at cost plus undistributed net earnings of such Subsidiaries applicable to such capital stock.

(h) The term "Tangible Assets" shall mean the total of all assets appearing on a Balance Sheet less the sum of

(i) the book amount of intangible assets, such as good will, trade marks, brands, trade names, patents and debt discount and expense;

(ii) any capital write-ups resulting from reappraisals of assets or investments subsequent to July 1, 1957, other than write-ups reflecting the undistributed net earnings of Subsidiaries;

(iii) any reserves carried by the Company as non-current liabilities and not already deducted from assets;

(iv) the amount, if any, by which the book value of investments in any corporation or corporations, except Subsidiaries, shall exceed

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the value of such investment based upon market quotations or, in the case of investments having no quoted market values, the fair value thereof (not in excess of cost) determined in good faith by the Board of Directors of the Company; and

(v) the amount, if any, at which the stock of the Company owned by the Company appears upon the asset side of such Balance Sheet;

provided that any determination of Tangible Assets shall be made in accordance with generally accepted principles of accounting.

(i) The term "Current Liabilities" shall mean the aggregate of such of the following as would appear on the liability side of a Balance Sheet:

(i) any and all loans, accounts, bills, notes, acceptances, bonds debentures or other obligations of any character payable on demand or maturing not more than 12 months after the particular time as of which the calculation is made;

(ii) dividends declared but not paid (other than dividends payable in shares of stock of the Company);

(iii) the aggregate amount of all accrued salaries, wages, interest rents and royalties and all estimated and accrued taxes;

(iv) any contingent current liabilities for which reserves are carried, in the amount of such reserves; and

(v) such other liabilities as may be properly included as "current" in accordance with generally accepted principles of accounting

provided that no indebtedness of any character shall for any purpose be deemed to be included in Current Liabilities if moneys sufficient to pay and discharge such indebtedness in full (either on the date of maturity expressed therein or on such earlier date as such indebtedness may be re deemed pursuant to the provisions thereof) shall have been deposited with the proper depositary or with a trustee in trust for the payment thereof

(j) The term "Net Tangible Assets" shall mean the balance remaining after deducting Current Liabilities from Tangible Assets.

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(k) The term "Net Income" shall mean the balance remaining after deducting from earnings and other income and profits of the Company all expenses and charges of every proper character, including, but not limited to, interest, amortization of debt discount and expense, if any, taxes or reserves for taxes, reasonable provision for depletion, depreciation and abandonment which provision, to the extent permitted by law, need not coincide with the amounts thereof reported for purposes of taxation, amounts appropriated under any plan for extra compensation for, or pension of, officers and employees, and usual and proper reserves all determined in good faith and in accordance with generally accepted principles of accounting.

(l) The term "Consolidated Net Income" shall mean the balance remaining after deducting from consolidated earnings and other income and profits of the Company and its Subsidiaries all expenses and charges of every proper character, including, but not limited to, interest, amortization of debt discount and expense, if any, taxes or reserves for taxes, reasonable provision for depletion, depreciation and abandonment, which provision, to the extent permitted by law, need not coincide with the amounts thereof reported for purposes of taxation, amounts appropriated under any plan for extra compensation for, or pension of, officers and employees, and usual and proper reserves, all determined in good faith and in accordance with generally accepted principles of accounting.

(m) The term "Current Indebtedness" shall mean indebtedness payable on demand or maturing by its terms in not more than 12 months from the particular time as of which the calculation is made.

(n) The term "Funded Indebtedness" shall mean indebtedness maturing by its terms more than 12 months after the particular time as of which the calculation is made; provided that no indebtedness of any character shall for any purpose be deemed to be included in Funded Indebtedness if moneys sufficient to pay and discharge such indebtedness in full (either on the date of maturity expressed therein or on such earlier date as such indebtedness may be redeemed pursuant to the provision thereof) shall have been deposited with the proper depositary or with a trustee in trust for the payment thereof.

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(o) The term "Subordinated Funded Indebtedness" shall mean the aggregate of all items of Funded Indebtedness of the Company which are or shall be, on any liquidation, dissolution, or other winding up of the Company, whether voluntary or involuntary, subordinate and subject in right of payment to the prior payment in full of the principal of and interest on the Debentures; provided that no payments of principal or interest shall be made on any such Subordinated Funded Indebtedness while there is a default under this Indenture.

(p) The term "Indenture" shall mean this instrument, together with all indentures supplemental hereto.

(q) The term "supplemental indenture" or "indenture supplemental hereto" shall mean any indenture duly authorized and entered into between the Company and the Trustee in accordance with the provisions hereof.

(r) The term "Debenture" shall mean any debenture authenticated and delivered hereunder.

(s) The term "outstanding," when used with respect to the Debentures, shall mean Debentures authenticated and delivered hereunder except

(i) Debentures theretofore cancelled by the Trustee or surrendered to the Trustee for cancellation;

(ii) Debentures for the payment or redemption of which cash shall have theretofore been deposited with the Trustee in trust for the holders of such Debentures, whether upon or prior to the maturity or redemption date of such Debentures; provided that, if such Debentures are to be redeemed prior to the maturity thereof, notice of such redemption shall have been duly published or provision satisfactory to the Trustee shall have been made therefor;

(iii) Debentures in lieu of and in substitution for which other Debentures shall have been authenticated and delivered pursuant to the terms of *Section 2.05*; and

(iv) Debentures held by the Company or by any Subsidiary in its treasury and not at the time pledged to secure any indebtedness.

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(t) The term "holder," when used with respect to a Debenture or Debentures which at the time are duly registered as to principal, shall mean the registered owner thereof.

(u) The term "Securities and Exchange Commission" shall mean the Commission by that name created under the Securities Exchange Act of 1934, or in case such Commission shall not be existing and performing the duties now performed by it, then the bodies performing the duties theretofore performed by said Securities and Exchange Commission.

(v) The term "Trust Indenture Act of 1939" shall, except for the purposes of *Section 12.03*, mean such Act as it was in force on the date of execution of this Indenture.

(w) The term "Trustee" shall mean the Trustee under this Indenture for the time being, whether original or successor.

(x) The term "New York Daily Newspaper" shall mean a newspaper printed in the English language and customarily published on each business day and of general circulation in the Borough of Manhattan, City and State of New York.

(y) The term "the date hereof" shall mean the date of the execution and delivery of this Indenture.

SECTION 1.02. Unless the context otherwise requires, all references to "*Articles*," "*Sections*," and other subdivisions are to the corresponding Articles, Sections and subdivisions of the Indenture, and the words "herein," "hereof," "hereunder," "hereby" and other words of similar import refer to the Indenture as a whole and not to any particular Article, Section or other subdivision hereof.

SECTION 1.03. Subject to the provisions of *Section 9.01*, a certificate of Independent Public Accountants shall be conclusive evidence as to all matters embraced in a Balance Sheet and as to the amount of Funded Indebtedness, Current Liabilities, Net Tangible Assets, Net Income and Consolidated Net Income.

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ARTICLE II.

Form, Execution and Registration.

SECTION 2.01. The Debentures shall be known as the "Eighteen Year 5% Debentures" of the Company. The Debentures shall be dated August 1, 1957, shall be payable on July 1, 1975, and shall bear interest at the rate of 5% per annum payable on the 1st day of January and the 1st day of July in each year. The definitive Debentures shall be engraved, or printed or lithographed with engraved borders, shall be issued in denominations of $50, $100 or $1,000 each and shall be numbered L1, in the case of Debentures in the denomination of $50, C1 in the case of Debentures in the denomination of $100, and M1 in the case of Debentures in the denomination of $1,000 and consecutively upward in each such case. Debentures in any of such denominations may be surrendered in exchange for Debentures of any other of such denominations of equivalent aggregate principal amount, in which event the Debenture or Debentures so surrendered shall be cancelled by the Trustee and delivered to the Company subject to the provisions of *Section 16.03* hereof. Any of the Debentures may be issued with appropriate insertions, omissions, substitutions and variations and may have imprinted thereon such legend or legends as may be required to comply with any law or any rules or regulations pursuant thereto or with the rules of any stock exchange or any governmental commission or with any provisions of this Indenture or to conform to general usage.

SECTION 2.02. The Debentures shall be executed on behalf of the Company by its President or a Vice-President (whose signatures may be facsimile) under its corporate seal, which may be printed, engraved or otherwise reproduced thereon, attested by its Secretary or an Assistant Secretary (whose signatures may also be facsimile). In case any person who, as an officer of the Company, shall have executed any Debenture or attested the seal of the Company thereon, shall cease to be such officer before such Debenture shall have been authenticated and delivered by the Trustee, such Debenture may nevertheless be authenticated, delivered and issued with the same effect as if such person had not ceased to be such officer. Any Debenture may be executed on behalf of the Company, and its corporate seal thereon may be attested, by such persons as at the actual

date of the execution of such Debenture shall be the proper officers of the Company, although at the date of such Debenture any such person was not such officer.

SECTION 2.03. Only such Debentures as shall bear thereon a certificate of authentication substantially in the form hereinbefore recited, executed by the Trustee, shall be entitled to the benefit hereof or be valid or obligatory for any purpose. Such certificate of authentication of the Trustee upon any Debenture shall be conclusive evidence that the Debenture so authenticated was duly executed by the Company, duly authenticated and delivered hereunder and that the holder is entitled to the benefit hereof.

SECTION 2.04. The Company will keep at the principal office of the Trustee a sufficient register or registers for the registration and transfer of the Debentures. Upon presentation thereof at such office for such purpose the Company will, under such reasonable regulations as it may prescribe, register any of the Debentures therein as to principal. The Company hereby constitutes and appoints the Trustee its Debenture registrar and transfer agent.

The holder of any Debenture may have the ownership of the principal thereof registered at such office, such registration being noted on the Debenture, after which registration and notation no transfer shall be valid unless made at such office by the registered holder in person or by his duly authorized attorney and similarly noted on the Debenture. Upon presentation at such office of any such Debenture registered as to principal accompanied by delivery of a written instrument of transfer in form satisfactory to the Trustee executed by the registered holder in person or by his duly authorized attorney, such Debenture shall be transferred upon such register and such transfer shall be noted on the Debenture. No service charge shall be made for any such registration or transfer, but the Company may require payment of a sum sufficient to cover any stamp tax or governmental charge that may be imposed in relation thereto.

SECTION 2.05. In case any Debenture, temporary or definitive, shall be mutilated, destroyed, lost or stolen, then, upon the production of such

mutilated Debenture, or upon the receipt of evidence satisfactory to the Company and the Trustee of the destruction, loss or theft of such Debenture, and upon receipt also of indemnity satisfactory to each of them, the Company in its discretion may execute, and thereupon the Trustee shall authenticate and deliver, a new Debenture in exchange for the mutilated Debenture, or in lieu of the Debenture so destroyed, lost or stolen, except that if any such mutilated, destroyed, lost or stolen Debenture shall have matured or shall be about to mature, the Company instead of issuing a substitute Debenture may, without surrender thereof (except in the case of mutilated Debentures), pay the same. Any such new Debenture delivered pursuant to this *Section 2.05* shall constitute an original additional contractual obligation on the part of the Company, whether or not the allegedly destroyed, lost or stolen Debenture be at any time enforceable by anyone, and shall be equally and proportionately entitled to the benefit of this Indenture with all other Debentures issued hereunder. Any mutilated Debenture in exchange for which a new Debenture shall be delivered pursuant to this *Section 2.05* shall be cancelled by the Trustee and delivered to the Company, subject to the provisions of *Section 16.03*. The Company, at its option, may require the payment of a sum sufficient to reimburse it for any stamp tax or other governmental charge connected with the issuance of any such new Debenture and also a further sum for any other expenses connected therewith.

ARTICLE III.

Issue of Debentures.

SECTION 3.01. The aggregate principal amount of Debentures which may be executed by the Company and authenticated by the Trustee is limited to the sum of $2,352,950 except as provided in *Sections 2.05* and *12.05*. Forthwith upon the execution and delivery hereof, or from time to time thereafter, Debentures in an aggregate principal amount not exceeding $2,352,950 may be executed by the Company and delivered to the Trustee for authentication, and thereupon shall be authenticated and delivered by the Trustee to or upon the written order of the Company signed by its President or a Vice-President and by its Secretary or an Assistant Secretary or its Treasurer or an Assistant Treasurer without any further corporate action on the part of the Company.

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ARTICLE IV.

Particular Covenants of the Company.

The Company covenants that so long as any of the Debentures are utstanding:

SECTION 4.01. The Company will duly and punctually pay the prinipal of and interest on the Debentures at the times and place and in the anner specified in the Debentures without deducting from the principal r interest for any Corporate Loans Tax or tax imposed in substitution herefor of the Commonwealth of Pennsylvania, not exceeding 4 mills per nnum in the aggregate upon each dollar of the principal amount of said ebentures lawfully subject to such tax which the Company may be reuired to pay or retain therefrom by any present or future law of the ommonwealth of Pennsylvania, the Company hereby agreeing to assume he payment of such taxes. Debentures when paid shall be cancelled by he Trustee and delivered to the Company, subject to the provisions of *ection 16.03*, and no Debentures shall be issued in lieu thereof.

SECTION 4.02. The Company will at all times keep or cause to be ept all of its properties and the properties of its Subsidiaries of a character sually insured by companies similarly situated adequately insured in such mounts as similar properties are usually insured by companies similarly ituated, against loss or damage of the kinds usually insured against by ompanies similarly situated, either by means of policies issued by reputale insurance companies, or, at its election, partially or wholly by means f an adequate insurance reserve set aside and maintained out of earnings f itself and its Subsidiaries or, in conjunction with other companies, hrough an insurance trust or other arrangement.

SECTION 4.03. The Company will at all times do and cause to be one for itself and each of its Subsidiaries all things necessary (a) to comly with all the requirements of the laws of any state or states of the nited States of America, or any other government, which may be aplicable; (b) except as otherwise permitted by this Indenture, to preserve nd keep in full force and effect its and their corporate existence and all anchises, rights and privileges heretofore or hereafter granted to or con-

ferred upon it or them, provided, however, that the corporate existence of any Subsidiary, or any franchise, right or privilege of the Company or any Subsidiary need not be maintained if, in the judgment of the Company, it shall be or become no longer advantageous to maintain the same; (c) to maintain, preserve and keep all its and their property in good repair, working order and condition, and to make or cause to be made any and all repairs thereto and renewals and replacements thereof and improvements thereto, which are deemed by it to be needful and proper, provided, however, that the Company or any Subsidiary may from time to time surrender, abandon, sell or otherwise treat or dispose of any property which in the judgment of the Company is no longer useful or of productive value or which may be advantageously surrendered, abandoned, sold or otherwise treated or disposed of in the proper conduct of the business of the Company or such Subsidiary; (d) promptly to pay and discharge when due all taxes, assessments and governmental charges levied or imposed upon it or them or upon its or their property, or any part thereof, or upon its or their income, profits or business, or any part thereof, or, in the case of the Company, upon moneys or property in possession of the Trustee pursuant to the provisions hereof, as well as all lawful claims for labor, materials and supplies or otherwise, or judgments, which if unpaid might become a lien or charge upon its or their property or any part thereof, provided, however, that (i) it or they may omit payment of any taxes, assessments and governmental charges levied upon any property which in the judgment of the Company has no value in excess of the amount of such taxes, assessments or governmental charges, (ii) it or they may omit payment of any such claims or judgments against any Subsidiary if in the judgment of the Company it shall be or become no longer advantageous to retain the property affected thereby or to maintain the corporate existence of such Subsidiary, or (iii) it and they shall have the right in good faith to contest any such tax, assessment, charge, judgment or claim and, pending such contest, to delay or refuse payment thereof, unless thereby property, income, profits, business or moneys which are essential, in the judgment of the Company, to the conduct of its or their business may be lost, forfeited or materially endangered, and when such payment shall be delayed or refused pending such contest, it or they shall set aside on its or their books such reserves, if any, as shall be deemed by the Company adequate with respect to any such tax, assessment, charge, claim, or judg-

ment; and (e) to set aside on its books reserves for depreciation, depletion and all other proper purposes in amounts (which, to the extent permitted by law, need not coincide with the amounts thereof reported for purposes of taxation) not less than such amounts as shall be required by good accounting practice as approved by Independent Public Accountants, provided that if depreciation shall be taken at an accelerated rate, the aggregate accumulated reserves shall, at all times, be at least equal to the aggregate reserves which would have been set aside had depreciation been taken during the same period on a straight-line basis.

SECTION 4.04. The Company will not sell, transfer or lease its property as an entirety or substantially as an entirety, or consolidate with or merge into any other corporation, or permit any other corporation to merge into it, in any manner which is prohibited by *Article XIII*.

SECTION 4.05. So long as any of the Debentures shall be outstanding, no dividend whatsoever whether in cash, stock or otherwise, shall be paid or declared, nor shall any distribution be made on the Common Stock or on shares of any other class of stock of the Corporation, nor shall any shares of Common Stock or any stock subordinate to the debentures be purchased, redeemed or otherwise acquired for valuable consideration by the Corporation or any of its subsidiaries, nor shall any moneys be paid to or set aside or made available for a sinking fund for the purchase or redemption of any such subordinate stock unless

(i) All interest on the debentures shall have been paid and the full amounts for the interest payments due during the current year and next succeeding fiscal year shall have been accrued and a sum sufficient for the payment thereof set apart; and

(ii) All amounts then or theretofore required to be set aside as and for the sinking fund for the debentures for the current year and the next succeeding fiscal year shall have been set aside and all defaults, if any, in complying with such sinking fund requirements in respect of previous years shall have been made good.

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SECTION 4.06. So long as any debentures are outstanding, the consent of the holders of at least 66⅔% of the debentures at the time outstanding, given in person or by proxy, either in writing or at a meeting called for that purpose, shall be necessary to effectuate or validate the action of the Company in doing or in authorizing or permitting any subsidiary to do, as the case may be, any one or more of the following:

(a) The increase in the authorized amount of these debentures or the authorization or the creation of any class of securities of the Company ranking on a parity with or prior to these debentures or the creation of any obligation which is convertible into or evidences the right to purchase any securities of the Company of any class ranking on a parity with or prior to these debentures.

(b) The voluntary dissolution liquidation or winding up of the Company;

(c) any amendment, alteration or repeal of any of the provisions of this indenture which would adversely affect the rights or preference of the debentures issued hereunder or the holders thereof; or

(d) The creation, issue and sale or assumption by the Company or any subsidiary of any funded debt or the giving by the Company or any subsidiary of any guarantee or similar obligation for the payment of funded debt; provided, however, that the paragraph (d) shall not apply to

(i) Any funded debt issued or sold or guarantee given, by any subsidiary to the Company, but the Company shall not, without like vote, dispose of such funded debt or guarantee unless prior thereto, or simultaneously therewith, all stock of such subsidiary owned by the corporation or any other subsidiary and all other indebtedness of such subsidiary owing to the Company or another subsidiary is sold or disposed of;

(ii) Any funded debt incurred for the purpose of extending, renewing or refunding any funded debt of the Company or a subsidi-

ary in a principal amount not more than the then principal amount of the funded debt so extended, renewed or refunded; or

(iii) Any funded debt incurred by the Company or any subsidiary in part payment of the cost of acquisition of any additional property acquired after July 1, 1957, which, if secured, shall be secured by mortgage or lien only on such additional property, or any funded debt secured by mortgage or other lien existing at the time of acquisition on additional property acquired after said date, if such mortgage or lien is such that it does not become a lien on any other property of the Company or any subsidiary; but only in every such case if (x) the aggregate amount of the funded debt so incurred or so secured by mortgage or lien on any additional property in any particular instance shall not at the time of acquisition of such property by the Company or such subsidiary exceed 60% of the cost (which shall be deemed to include the amount of all indebtedness secured by liens, including existing liens on such property) of such property to the Company or such subsidiary, or 60% of the fair market value thereof (disregarding all indebtedness secured by liens on such property), whichever shall be less at the time of acquisition thereof by the Company or such subsidiary, and the determination by the Board of Directors of the Company of such fair market value shall, in the absence of fraud, be conclusive, and (y) the aggregate of the funded debt at the time outstanding and incurred in connection with the acquisition of or secured by mortgage or lien existing on, all such additional property shall not exceed $1,200,000.00 in aggregate principal amount.

SECTION 4.07. So long as any Debentures are outstanding, the consent of the holders of at least 50% of such Debentures at the time outstanding, given in person or by proxy either in writing or at a meeting called for that purpose, shall be necessary to effectuate or validate the action of the Company in doing, or in authorizing or permitting any subsidiary to do, as the case may be, any one or more of the following:

(a) The sale, lease, conveyance or other voluntary parting with control by the Company of all or substantially all of its assets, unless prior

thereto, all of the Debentures secured hereby have been or, simultaneously with the consummation of such transaction, are to be retired;

(b) The merger or consolidation of the Company into or with any other corporation, or the merger of any other corporation into the Company unless the corporation resulting from such merger or consolidation will have, after such merger or consolidation, no other securities either authorized or outstanding ranking prior to or on a parity with the Debentures or convertible into or evidencing the right to purchase any class of securities ranking on a parity with or prior to the Debentures.

(c) The sale or other disposition, directly or indirectly (except to the Company), of shares of a subsidiary whereby such subsidiary shall cease to be a subsidiary of the Company; provided, however, that this provision shall not apply if by such sale or other disposition all shares of every class of such subsidiary owned by the Company or by any other subsidiary and all indebtedness of such subsidiary owing by the Company or any other subsidiary shall be disposed of;

(d) The merger or consolidation of any subsidiary into or with any other corporation or the merger of any other corporation into a subsidiary, unless in any of such cases, such other corporation be the Company and such merger or consolidation may be made under Paragraph (b) above without a vote of the holders of the Debentures.

(e) The creation, authorization or issue by any subsidiary of any stock ranking prior to the common stock of such subsidiary or of any stock or other security convertible into or exchangeable for shares of stock of any class ranking prior to such common stock; provided, however, that this provision shall not prevent the creation by any subsidiary of any such prior stock or convertible stock or other security for issuance, and the issuance or sale thereof, to the Company; but in any such event, the Company shall not, without like vote, sell or dispose of such prior stock or convertible or other security unless prior thereto or simultaneously therewith all other stock of such subsidiary owned by the Company or any other subsidiary and all indebtedness of such subsidiary owing to the Company or any other subsidiary is sold or disposed of; or

(f) Purchase, redeem or otherwise acquire for a valuable consideration any Debentures at a time when interest on the Debentures for all past due dates shall not have been fully paid and a sum sufficient for the payment thereof set apart: provided, however, that the Company may, nevertheless, without such consent of the holders of the Debentures purchase Debentures at any such time it shall have (i) given the holders of all Debentures then outstanding notice in writing addressed to them at their respective addresses appearing on the books of the Trustee of its desire to purchase Debentures and the amount of cash available for such purchase, and in such notice shall have requested tenders of Debentures for sale to the Company on a date specified in such notice, which shall be at least 30 days after the date of mailing such notice, and (ii) purchase such Debentures pursuant to such tenders at prices not exceeding the price applicable for the redemption of Debentures on such date, unless the cash to be applied to such purchase constitutes sinking fund monies, then at prices not exceeding the price then applicable for the redemption of Debentures for sinking fund on that date and (iii) purchase such Debentures in the order of the prices at which the same were offered to the Company, pursuant to such request for tenders as aforesaid, commencing with the Debentures tendered at the lowest price, except that if several acceptable tenders at the same price shall have been received, the Company may make a ratable acceptance thereof or may select one or more of said tenders for acceptance in whole or in part as it shall elect. The provision permitting the Company to purchase Debentures as aforesaid shall not be deemed to require it to accept any or all of the Debentures tendered as aforesaid, but merely to require that any Debentures purchased on the existence of a default in the payment of interest as aforesaid shall be purchased only upon consent or through tenders as above provided. The provisions of this paragraph shall not in any way restrict the right of any holder of Debentures to surrender or the corporation to receive Debentures in exchange for shares of common stock, in such manner as the Board of Directors may present.

SECTION 4.08. From time to time, whenever reasonably demanded by the Trustee, the Company will make, execute and deliver, or cause to be made, executed and delivered, all such further and other instruments and assurances as may be reasonably necessary or proper to carry out the

intention or to facilitate the performance of the terms hereof, or to secu the rights and remedies hereunder of the holders of the Debentures.

SECTION 4.09. The Company will, within 120 days after the close each fiscal year, beginning with the fiscal year ending April 30, 1958, cau to be filed with the Trustee a statement of the Independent Public A countants who shall have examined the financial statements of the Co pany and its Subsidiaries for the preceding fiscal year that in their exam nation they have found no evidence of any default on the part of t Company in the performance and observance of any of the covenan contained in *Sections 4.05* to *4.08* of this *Article IV* with respect to fina cial or accounting matters, or, if they have found evidence of any su default, a statement specifying the nature thereof. In the absence of b faith, the Independent Public Accountants furnishing such statement sh not be liable, directly or indirectly, to anyone for any failure to obta knowledge of any default.

SECTION 4.10. The Company hereby constitutes and appoints t Trustee its paying agent in respect of the Debentures and the Compa will not itself act as a paying agent in respect of any of the Debentu or appoint any paying agent other than the Trustee. The Trustee sh hold all sums received in respect of the Debentures in trust for the p poses for which said sums are paid.

SECTION 4.11. So long as any of the debentures shall be outstandi the Company shall maintain a net working capital of at least One Milli Dollars ($1,000,000) and shall maintain a ratio of current assets to curre liabilities at the end of each fiscal year of at least two hundred per c (200%).

As used herein the term "net working capital" shall mean the exc of the Company's current assets over its current liabilities all as determin and computed in accordance with generally accepted accounting prin ples, the term "current liabilities" including the payment of the sinki fund requirements for the current fiscal year.

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SECTION 4.12. The Company will reimburse the owner of any Debenture for any and all personal property taxes lawfully imposed by the Commonwealth of Pennsylvania or any political subdivision thereof by reason of the ownership of such Debenture by a resident of Pennsylvania under any present or future law of said Commonwealth of Pennsylvania or any political subdivision thereof, not exceeding 4 mills per annum in the aggregate on each dollar of taxable value of such Debenture, provided that such tax shall have been paid by such owner and application for such reimbursement shall have been made within 60 days after the payment of such tax as hereinafter provided. Such reimbursement shall be made upon the written application of such owner in form satisfactory to the Company stating (a) the number of each such Debenture, (b) that he was the owner thereof and a resident of Pennsylvania on the date when such tax was assessed, (c) that he was assessed and did pay such tax, giving the amount thereof and the date of payment and, upon submission, if required by the Company, of all receipted tax bills and/or other documentary evidence establishing the payment of such tax. Such application shall be made to the Company at the principal office of the Trustee within a period of 60 days from the date of the payment of the tax and within 6 months after such tax shall have become due and payable. The Company shall in no event be liable to reimburse any registered owner of a Debenture for any interest or penalties assessed or paid by him in addition to the amount of such tax as originally assessed.

ARTICLE V.

Redemption and Subordination.

SECTION 5.01. The Company may, at its option (which may be exercised upon authorization by the Board of Directors), redeem the Debentures at any time outstanding, as a whole at any time, or in part, from time to time, by giving notice as herein provided and by paying or providing for the payment in cash of the redemption price of one hundred per cent of the face amount of such Debenture, plus in each case, interest accrued thereon to the date fixed for such redemption. In case of the redemption of only part of the Debentures at the time outstanding, the Debentures to be redeemed shall be selected pro-rata or by lot or in such manner as the Board of Directors may determine. Subject to the

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provisions and limitations contained herein, the Board of Directors shall have full power and authority to prescribe the manner in which and the terms and conditions upon which such Debentures shall be redeemed from time to time.

If the redemption date of any Debentures be (a) a Sunday or legal holiday, or (b) a day on which banking institutions are authorized pursuant to law to close and on which the principal office of the Trustee is not open for business, then payment of the redemption price and any accrued interest payable upon redemption may be made on the next succeeding day, not a day specified in (a) or (b) above, with the same force and effect as if made on the redemption date, and no interest shall accrue for the period after such redemption date.

SECTION 5.02. Notice of redemption shall be given by the Company by causing a notice to be published once in each calendar week (in each instance on any business day of the week) for at least 4 successive weeks in a New York Daily Newspaper (which need not be the same newspaper for all such publications) the first publication to be not less than 30 days nor more than 60 days prior to the redemption date, which said notice shall specify, if less than all are to be redeemed, the serial numbers of the Debentures to be redeemed, the redemption price, the redemption date and the place where payment will be made. A copy of such notice shall be mailed by the Company by ordinary mail, postage prepaid, at least 30 and not more than 60 days prior to the redemption date to the registered holders of Debentures at the time registered as to principal which are to be redeemed, at their last addresses as they shall appear on the register provided for in *Section 2.04*, but failure to give such additional notice by mail, or any defect therein, shall not affect the validity of the proceedings for the redemption of any of the Debentures.

Notice of redemption having been published as above provided, the Debentures designated for redemption shall become due and payable on the redemption date, at the redemption price applicable at the time together with accrued interest to the redemption date. As to the publication of any notice of redemption the affidavit of any employee of the news-

paper directed to make such publication shall be full and complete authority to the Trustee for any action to be taken by it in reliance thereon, except as otherwise provided in *Section 9.01* hereof. The Company covenants and agrees that it will, on or before the redemption date specified in such notice, deposit with the Trustee a sum equal to the redemption price of the Debentures to be redeemed together with accrued interest to the redemption date. The Trustee shall hold all moneys deposited with it for the redemption of Debentures in trust for the benefit of the holders of such Debentures. Payment of the redemption price together with accrued interest to the redemption date (except that if such date be an interest payment date such payment shall not include such accrued interest) shall be made to the respective holders of the Debentures which have been called for redemption, upon surrender of such Debentures, at the principal office of the Trustee, and in case of Debentures registered as to principal duly endorsed or accompanied by duly executed instruments of transfer satisfactory to the Trustee.

Notice of redemption having been published as above provided, or provision therefor satisfactory to the Trustee having been made, if on or before the redemption date the moneys necessary for such redemption shall have been deposited with the Trustee for the pro rata benefit of the holders of the Debentures so called for redemption then such Debentures shall thereupon cease to be entitled to the benefit hereof, except the right to receive a new Debenture, or cash in lieu thereof, in substitution for a mutilated, destroyed, lost or stolen Debenture upon the terms provided in *Section 2.05*, and from and after the redemption date, notwithstanding that any Debentures so called for redemption shall not have been surrendered, no further interest shall accrue upon any Debenture so called for redemption.

SECTION 5.03. If less than all the Debentures are to be redeemed the Company shall give the Trustee adequate notice in advance as to the aggregate principal amount of Debentures to be redeemed, and thereupon the Trustee shall draw by lot, in such manner as it may deem appropriate and fair, the serial numbers of the Debentures to be redeemed and shall thereafter promptly notify the Company in writing of the serial numbers of the Debentures so to be redeemed.

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SECTION 5.04. Debentures redeemed as provided in this *Article V* shall be cancelled by the Trustee and delivered to the Company, subject to the provisions of *Section 16.03*, and no Debentures shall be issued in place thereof.

Subordination

SECTION 5.05. This Indenture and the Debentures issued hereunder shall be subordinate only to current bank borrowings for inventory purposes which obligations mature by their original terms in less than twelve months and obligations of the Company to suppliers of materials, services and labor incurred in the normal course of the Company's business and reasonably required in its operations, which obligations are due and payable when billed, and to any existing liens, encumbrances, mortgages, conditional sales agreements, or pledges, or any replacement, renewal, or extension thereof and any funded indebtedness created hereafter in the manner and in accordance with the terms of *Section 4.06* of *Article IV* hereof.

ARTICLE VI.

Sinking Fund.

SECTION 6.01. The Company covenants and agrees that on or before the expiration of 90 days after the end of each fiscal year of the Company commencing with the fiscal year ending April 30, 1959, it will pay to the Trustee as and for a contingent sinking fund for the redemption of Debentures at the sinking fund redemption price of 100% of the principal amount of the Debentures so to be redeemed, together with accrued interest to the redemption date, a sum in lawful money of the United States of America sufficient to redeem $196,080 principal amount of said Debentures, provided that in any year when the Consolidated Net Income is insufficient to redeem $196,080 principal amount of said Debentures the amount required to be paid over to the Trustee shall be 100% of such Consolidated Net Income and the difference between that sum and $196,080 shall accumulate to be paid from the Consolidated Net Income of subsequent

years and provided further that the Company must commence the accumulation of income for sinking fund purposes by setting aside 100% of Consolidated Net Income up to $196,080 in each year commencing with the year beginning May 1, 1957.

On or before the expiration of 90 days after the end of each such fiscal year, the Company shall furnish to the Trustee a certificate of Independent Public Accountants stating the amount of the contingent sinking fund payment required to be made by the Company pursuant to this *Section 6.01* which certificate shall comply with the provisions of *Section 9.07* hereof.

SECTION 6.02. If on any sinking fund payment date provided for in *Section 6.01*, the amount of cash then paid into the sinking fund, together with all other cash then in said fund, shall in the aggregate be sufficient to redeem at least $10,000 aggregate principal amount of Debentures at the sinking fund redemption price together with accrued interest, the Trustee shall select for redemption the largest aggregate principal amount of Debentures redeemable with such cash on the next succeeding interest payment date. The Trustee shall make such selection by drawing by lot, in such manner as it may elect, from the serial numbers of all Debentures then outstanding, the serial numbers of the Debentures which are to be redeemed; and the Trustee shall thereupon cause notice to be given, in the name and at the expense of the Company, that the Debentures so selected will be redeemed at the principal office of the Trustee on the next succeeding interest payment date. Such notice shall be given in the same manner and with like effect as is provided in *Article V*; and the Trustee shall cause such Debentures to be redeemed and paid in accordance with such notice in the manner and with the effect provided in *Article V*.

If on any sinking fund payment date the aggregate amount of cash in the sinking fund shall not be sufficient to redeem at least $10,000 aggregate principal amount of Debentures at the sinking fund redemption price, such cash shall be retained by the Trustee in the sinking fund and shall be applied with succeeding sinking fund instalments to the redemption of Debentures as provided above; provided, however, that any such cash may

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(b) In case 3 or more holders of Debentures (hereinafter referred to as "applicants") apply in writing to the Trustee, and furnish to the Trustee reasonable proof that each such applicant has owned a Debenture for a period of at least 6 months preceding the date of such application, and such application states that the applicants desire to communicate with other holders of Debentures with respect to their rights hereunder or under the Debentures, and is accompanied by a copy of the form of proxy or other communication which such applicants propose to transmit, then the Trustee shall, within 5 business days after the receipt of such application, at its election, either

(i) afford such applicants access to the information preserved at the time by the Trustee in accordance with the provisions of *subsection* (*a*) of this *Section 7.02;* or

(ii) inform such applicants as to the approximate number of holders of Debentures whose names and addresses appear in the information preserved at the time by the Trustee in accordance with the provisions of *subsection* (*a*) of this *Section 7.02*, and as to the approximate cost of mailing to such Debenture holders the form of proxy or other communication, if any, specified in such application.

If the Trustee shall elect not to afford such applicants access to such information, the Trustee shall, upon the written request of such applicants, mail to each Debenture holder whose name and address appears in the information preserved at the time by the Trustee in accordance with the provisions of *subsection* (*a*) of this *Section 7.02*, a copy of the form of proxy or other communication which is specified in such request, with reasonable promptness after a tender to the Trustee of the material to be mailed and of payment or provision for the payment of the reasonable expenses of mailing unless within 5 days after such tender the Trustee shall mail to such applicants and file with the Securities and Exchange Commission together with a copy of the material to be mailed, a written statement to the effect that, in the opinion of the Trustee, such mailing would be contrary to the best interests of the holders of Debentures or would be in violation of applicable law. Such written statement shall specify the basis of such opinion. If said Commission, after opportunity for a hearing upon the objections specified in the written statement so

filed, shall enter an order refusing to sustain any of such objections or if, after the entry of an order sustaining one or more of such objections, said Commission shall find, after notice and opportunity for a hearing, that all the objections so sustained have been met and shall enter an order so declaring, the Trustee shall mail copies of such material to all such Debenture holders with reasonable promptness after the entry of such order and the renewal of such tender; otherwise the Trustee shall be relieved of any obligation or duty to such applicants respecting their application.

(c) Each and every holder of Debentures, by receiving and holding the same, agrees with the Company and the Trustee that neither the Company nor the Trustee shall be held accountable by reason of the disclosure of any information as to the names and addresses of the holders of Debentures in accordance with the provisions of *subsection (b)* of this *Section 7.02* regardless of the source from which such information was derived, and that the Trustee shall not be held accountable by reason of mailing any material pursuant to a request made under said *subsection (b)*.

SECTION 7.03. (a) The Company covenants and agrees to file with the Trustee, within 15 days after the Company is required to file the same with the Securities and Exchange Commission, copies of the annual reports and of the information, documents and other reports (or copies of such portions of any of the foregoing as such Commission may from time to time by rules and regulations prescribe) which the Company may be required to file with such Commission pursuant to Section 13 or Section 15(d) of the Securities Exchange Act of 1934; or, if the Company is not required to file information, documents or reports pursuant to either of such sections, then to file with the Trustee and the Securities and Exchange Commission, in accordance with rules and regulations prescribed from time to time by said Commission, such of the supplementary and periodic information, documents and reports which may be required pursuant to Section 13 of the Securities Exchange Act of 1934 in respect of a security listed and registered on a national securities exchange as may be prescribed from time to time in such rules and regulations.

(b) The Company covenants and agrees to file with the Trustee and the Securities and Exchange Commission, in accordance with the rules and regulations prescribed from time to time by said Commission, such addi-

tional information, documents and reports with respect to compliance by the Company with the conditions and covenants provided for in this Indenture as may be required from time to time by such rules and regulations.

(c) The Company covenants and agrees to transmit to the holders of Debentures within 30 days after the filing thereof with the Trustee, in the manner and to the extent provided in *subsection (c)* of *Section 7.04* with respect to reports pursuant to *subsection (a)* of *Section 7.04*, such summaries of any information, documents and reports required to be filed by the Company pursuant to *subsections (a)* and *(b) of this Section 7.03* as may be required by the rules and regulations prescribed from time to time by the Securities and Exchange Commission.

SECTION 7.04. (a) The Trustee shall transmit, within 60 days after July 1 in each year beginning with the year 1958, to the Debenture holders as hereinafter in this *Section 7.04* provided, a brief report dated as of July 1 of such year, with respect to:

(i) its eligibility under *Section 9.09* and its qualification under *Section 9.08*, or, in lieu thereof, if to the best of its knowledge it has continued to be eligible and qualified under such *Sections*, a written statement to such effect;

(ii) the character and amount of any advances (and if the Trustee elects so to state, the circumstances surrounding the making thereof) made by the Trustee as such, which remain unpaid on the date of such report, and for the reimbursement of which it claims or may claim a lien or charge, prior to that of the Debentures, on any property or funds held or collected by it as Trustee, if such advances so remaining unpaid aggregate more than ½% of the principal amount of the Debenture outstanding on the date of such report;

(iii) the amount, interest rate and maturity date of all other indebtedness owing by the Company or any other obligor upon the Debentures to the Trustee in its individual capacity on the date of such report, with a brief description of any property held as collateral security therefor, except an indebtedness based upon a creditor relationship arising in any manner described in *paragraphs (ii), (iii), (iv)* or *(vi)* of *subsection (b)* of *Section 9.13;*

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(iv) the property, and funds, if any, physically in the possession of the Trustee as such on the date of such report; and

(v) any action taken by the Trustee in the performance of its duties hereunder which it has not previously reported and which in its opinion materially affects the Debentures, except action in respect of a default, notice of which has been or is to be withheld by it in accordance with the provisions of *Section 8.11*.

(b) The Trustee shall transmit to the Debenture holders as hereinafter provided a brief report with respect to the character and amount of any advances (and if the Trustee elects so to state, the circumstances surrounding the making thereof) made by the Trustee as such since the date of the last report transmitted pursuant to the provisions of *subsection (a)* of this *Section 7.04* (or if no such report has yet been so transmitted, since the date of execution of this Indenture), for the reimbursement of which it claims or may claim a lien or charge prior to that of the Debentures on property or funds held or collected by it as Trustee, and which it has not previously reported pursuant to this subsection, if such advances remaining unpaid at any time aggregate more than 10% of the principal amount of the outstanding Debentures, such report to be transmitted within 90 days after such time.

(c) Reports pursuant to this *Section 7.04* shall be transmitted by mail:

(i) to all registered holders of Debentures, as the names and addresses of such holders appear upon the registration books of the Company;

(ii) to such holders of Debentures as have, within 2 years preceding such transmission, filed their names and addresses with the Trustee for that purpose; and

(iii) except in the case of reports pursuant to *subsection (b)* of this *Section 7.04* to each Debenture holder whose name and address is preserved at the time by the Trustee, as provided in *subsection (a)* of *Section 7.02*.

(d) A copy of each such report shall, at the time of such transmission to Debenture holders, be filed by the Trustee with each stock exchange

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upon which the Debentures are listed and also with the Securities and Exchange Commission. The Company agrees to notify the Trustee when and as the Debentures become listed on any stock exchange.

(e) For the purpose of this *Section 7.04* all Debentures which have been authenticated and delivered and not returned to the Trustee and cancelled shall be deemed to be outstanding.

ARTICLE VIII.

Remedies of Trustee and Debenture Holders on Default.

SECTION 8.01. The following events are hereby defined for all purposes of this Indenture as "defaults" (except where the term is otherwise defined for specific purposes):

(a) Failure to pay the principal of any of the Debentures when and as the same shall become due and payable, whether at maturity as therein expressed or otherwise as herein provided;

(b) Failure to pay any instalment of interest on any of the Debentures for a period of 30 days after such interest shall have become due and payable;

(c) Failure to pay or satisfy any sinking fund instalment for a period of 30 days after such instalment shall have become due and payable;

(d) Failure duly to observe and perform any other covenant, agreement or condition contained in this Indenture, or in the Debentures, required to be performed by the Company, which failure shall have continued for a period of 60 days after written notice thereof shall have been given to the Company by the Trustee, or to the Company and the Trustee by the holders of at least 20% in aggregate principal amount of the outstanding Debentures;

(e) The expiration of a period of 60 days following:

(i) the adjudication of the Company as a bankrupt by any court of competent jurisdiction;

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(ii) the entry of an order approving a petition seeking reorganization or arrangement of the Company under the Federal bankruptcy laws or any similar applicable law or statute of the United States of America or of any State thereof, as now existing or hereafter in effect; or

(iii) the appointment of a trustee, liquidator or receiver of a major part of the property of the Company;

except that there shall be excluded from such period any time during which such adjudication, order or appointment of a trustee, liquidator or receiver shall be vacated or shall be stayed on appeal or otherwise or shall have otherwise ceased to continue in effect;

(f) The filing by the Company of a voluntary petition in bankruptcy or the making by it of an assignment for the benefit of creditors; the consenting by the Company to the appointment of a receiver, liquidator or trustee of a major part of its property; the filing by the Company of a petition or answer seeking reorganization or arrangement under the Federal bankruptcy laws or any similar applicable law or statute of the United States of America or of any State thereof, as now existing or hereafter in effect; or the filing by the Company of a petition to take advantage of any insolvency act;

(g) The rendering against the Company of final judgment for the payment of money in excess of $100,000 and the failure of the Company to appeal therefrom (or from the order, decree or process pursuant to which such judgment was granted, passed, entered or affirmed) or to petition for certiorari, mandamus or prohibition or to pursue some other available legal remedy for reversal or vacation thereof, and to obtain a stay of execution thereof within the period prescribed or permitted by law, pending such appeal or pending the disposition of such petition or the pursuit of any such other remedy, and/or to have such judgment discharged within 60 days after the expiration of such period or of the period of any such stay, whichever shall later expire; or

(h) The occurrence of a default or an event of default (i) under any other indenture or agreement pursuant to which any bonds, deben-

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tures, notes or other evidences of debt of the Company in respect of moneys borrowed may be issued or (ii) pursuant to the terms of any bonds, debentures, notes or other evidences of debt of the Company in respect of moneys borrowed not issued under an indenture or agreement, in either case if such default or event of default shall continue beyond the period of grace, if any, therein specified.

If any one or more of the defaults shall occur and be continuing, then unless the principal of all the Debentures shall already be due and payable, either the Trustee, by notice in writing to the Company, or the holders of not less than 20% in aggregate principal amount of the outstanding Debentures, by notice in writing to the Company and the Trustee, may declare the principal of all the Debentures then outstanding to be due and payable immediately, and upon any such declaration the same shall become and shall be due and payable immediately, anything in this Indenture or in the Debentures contained to the contrary notwithstanding.

This provision, however, is subject to the condition that if, at any time after the principal of the Debentures shall have been so declared and become due and payable, and before any sale of property shall have been had under any judgment or decree for the payment of the moneys due which shall have been obtained or entered as hereinafter provided, the Company shall pay, or shall deposit with the Trustee a sum sufficient to pay, all matured instalments of interest, if any, upon all the Debentures, with interest on overdue instalments of interest at the rate of 6% per annum to the date of such payment or deposit, and the expenses of the Trustee, and any and all other defaults shall have been remedied and made good to the satisfaction of the Trustee or provision therefor satisfactory to the Trustee shall have been made or shall have been waived as in *Section 8.10* provided, then and in every such case holders of a majority in aggregate principal amount of the outstanding Debentures, by written notice to the Company and to the Trustee, may waive such default or defaults and rescind and annul such declaration and its consequences, upon such terms, conditions and agreements, if any, as they may determine; but no such waiver or rescission and annulment shall extend to or shall affect any subsequent default, or shall impair any right consequent thereon. Any such waiver by the holder of a Debenture shall be conclusive and binding upon such holder and upon all future holders thereof or of any Debenture issued in lieu thereof, irre-

spective of whether or not any notation of such waiver is made upon the Debenture.

SECTION 8.02. The Company covenants that in case any default of the character specified in *subsections (a)* or *(b)* of *Section 8.01* shall occur, then, upon demand of the Trustee, the Company will pay to the Trustee, for the benefit of the holders of the Debentures then outstanding, the whole amount that then shall have become due and payable on all such Debentures for principal, premium and interest, with interest upon any overdue principal, premium and interest at the rate of 6% per annum, and, in addition thereto, such further amount as shall be sufficient to cover the costs and expenses of collection, including reasonable compensation to the Trustee, its agents, attorneys and counsel, and any expenses or liabilities incurred by the Trustee hereunder without negligence or bad faith

Until such demand is made by the Trustee, the Company may pay the principal and interest of or on the Debentures as herein provided whether or not the payments are overdue.

In case the Company shall fail to pay such amounts upon such demand, the Trustee, in its own name and as trustee of an express trust, shall be entitled to recover judgment against the Company or any other obligor on the Debentures for the whole amount thereof and to issue execution thereon against the whole or any part of the property of the Company or any obligor on the Debentures.

SECTION 8.03. In case there shall be pending proceedings for the bankruptcy or for the reorganization or arrangement of the Company or any other obligor on the Debentures under the Federal bankruptcy laws or any similar applicable law as now existing or hereafter in effect, or in connection with the insolvency of the Company or any other obligor on the Debentures, or in case a liquidator, receiver or trustee shall have been appointed for its property, or in case there shall be pending any other proceedings in respect of the Company or any other obligor on the Debentures or its creditors or its property, the Trustee may file such proof of claim and other petitions, papers or documents as may be necessary or advisable in order to have the claims of the Trustee and of the Debenture holders al-

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lowed in any such judicial proceedings; and, irrespective of whether the principal of all of the Debentures shall then be due and payable as therein expressed or otherwise, and irrespective of whether the Trustee shall have made any demand pursuant to the provisions of *Section 8.02*, the Trustee shall be entitled and empowered to file and prove a claim for the whole amount of principal and interest owing and unpaid in respect of the Debentures, and to collect and receive any moneys or other property payable or deliverable on any such claim, and to distribute the same after the deduction of its charges and expenses; and any receiver, liquidator, assignee or trustee in bankruptcy, trustee in reorganization, or trustee or debtor in any proceedings for the adoption of an arrangement, is hereby authorized by each of the Debenture holders to make such payments to the Trustee, and, in the event that the Trustee shall consent to the making of such payments directly to the Debenture holders, to pay to the Trustee any amount due it for compensation and expenses, including counsel fees incurred by it up to the date of such distribution.

In any such proceedings, the Trustee may file a proof of claim as a creditor for its reasonable compensation, expenses and advances (including the reasonable compensation and expenses of its counsel and of all persons not regularly in its employ) earned, made or incurred, as the case may be, by it in the execution of the trusts hereby created and in the exercise and performance of any of the powers and duties herein of the Trustee. Each holder of any Debenture by his acceptance thereof agrees that to the extent that an allowance out of the estate in any such proceedings with respect to such reasonable compensation, reimbursement and indemnity may be denied to the Trustee or to its counsel or other agents for any reason, the court may nevertheless allow such claim in any such proceedings, and for the purposes of any plan of reorganization or arrangement, may classify the Trustee as a secured creditor having priority over the class in which the holders of the Debentures are placed, and each Debenture holder further agrees that the Trustee, for the purposes of such claim, shall, in priority to the holders of the Debentures, (a) be entitled to receive and collect such claim out of all distributions of securities or dividends or other disbursements which would otherwise be made to the holders of the Debentures in any such proceedings, and (b) have a lien upon all securities and other considerations to which the holders of the Debentures may become en-

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titled pursuant to any plan of reorganization or arrangement in any such proceedings; and the court may determine the method and conditions under which any such distributions may be made and lien enforced.

SECTION 8.04. All rights of action and of asserting claims under this Indenture or under any of the Debentures may be enforced by the Trustee without the possession of any of the Debentures or the production thereof on any trial or other proceedings relative thereto, and any such suit or proceedings instituted by the Trustee shall be brought in its own name and as trustee of an express trust, and any recovery of judgment shall be for the equal and ratable benefit of the holders of the Debentures in respect of which or for the benefit of whom any such recovery shall have been obtained. In any proceedings brought by the Trustee and in any proceedings involving the interpretation of any provision hereof to which the Trustee shall be a party, the Trustee shall be held to represent all the holders of the Debentures and it shall not be necessary to make any holders of the Debentures parties to any such proceedings.

SECTION 8.05. Any moneys collected or received by the Trustee under this *Article VIII*, together with any other moneys then in the hands of the Trustee available for such purposes, shall be applied by the Trustee, at the date or dates fixed by the Trustee for the distribution of such moneys, as follows:

First. To the payment of the costs and expenses of collection, including reasonable compensation to the Trustee, its agents, attorneys and counsel, and all expenses, liabilities and advances made or incurred by the Trustee without negligence or bad faith.

Second. In case the principal of the Debentures shall not have become and be then due and payable, to the payment of the interest in default, in the order of the maturity of the instalments of such interest, with interest on the overdue instalments at the rate of 6% per annum, such payments to be made ratably to the persons entitled thereto, without discrimination or preference.

Third. In case the principal of any of the Debentures shall have become and shall be then due and payable, to the payment of the

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whole amount then due and unpaid for principal and interest, upo the Debentures in respect of which or for the benefit of which suc moneys shall have been collected with interest on the overdue princi pal and interest at the rate of 6% per annum; and in case such money shall be insufficient to pay in full the whole amount so due and unpai upon all the Debentures, then to the payment of such principal an interest, without preference or priority among principal and interes or among different instalments of interest, equally and ratably to th aggregate of such principal and interest. Such payments shall be mad only upon presentation of the several Debentures for stamping thereo the payment if only partially paid, and upon surrender thereof if full paid.

Fourth. To the payment of the remainder, if any, to the Com pany, its successors or assigns, or to whomsoever may be lawfully en titled to receive the same, or as a court of competent jurisdiction ma direct.

SECTION 8.06. No delay or omission of the Trustee or of any holde of any of the Debentures to exercise any right or power accruing upon an default shall impair any such right or power, or shall be construed to be waiver of any such default or an acquiescence therein; and except as herei otherwise expressly provided, every power and remedy given hereby to th Trustee or to the holders of Debentures shall be cumulative and not ex clusive and in addition to every other remedy existing at law or in equit or by statute, and may be exercised from time to time, and as often as sha be deemed expedient, by the Trustee or by the holders of Debentures.

SECTION 8.07. In case the Trustee shall have proceeded to enforc any right hereunder, and such proceedings shall have been discontinued o abandoned for any reason, or shall have been determined adversely to th Trustee, then and in every such case the Company and the Trustee shall b restored respectively to their several positions and rights hereunder, and a rights, remedies and powers of the Trustee shall continue as though n such proceedings had been taken.

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SECTION 8.08. No holder of any Debenture shall have any right to institute any suit, action or proceeding at law or in equity for any remedy hereunder, unless (a) such holder previously shall have given to the Trustee written notice of default and of the continuance thereof, and (b) the holders of not less than 20% in aggregate principal amount of the outstanding Debentures shall have made written request upon the Trustee to institute such suit, action or proceeding in its own name, and shall have offered to the Trustee reasonable indemnity and security against the costs, expenses and liabilities to be incurred therein or thereby, and (c) the Trustee for a period of 60 days after receipt of such notice, request and offer of indemnity, shall have neglected or refused to institute any such action, suit or proceeding and (d) no directions inconsistent with such written request shall have been given the Trustee pursuant to *Section 8.10;* it being expressly covenanted by each holder of a Debenture with every other holder, with the Trustee and with the Company, that no one or more holders of Debentures shall have any right in any manner whatever to affect, disturb or prejudice the rights of the holders of any other such Debentures, or to obtain or seek to obtain priority over or preference to any other such holder, or to enforce any right under this Indenture except in the manner herein provided and for the equal, ratable and common benefit of all holders of outstanding Debentures. For the protection and enforcement of the provisions of this *Section 8.08*, each and every Debenture holder and the Trustee shall be entitled to such relief as can be given either at law or in equity.

SECTION 8.09. Notwithstanding any other provisions of this Indenture, the right of any holder of a Debenture to receive payment of the principal of and interest on such Debenture, on or after the respective due dates expressed in such Debenture and to institute suit for enforcement of any such payment on or after such respective dates, shall not be impaired or affected without the consent of such holder.

SECTION 8.10. The holders of at least a majority in aggregate principal amount of the outstanding Debentures shall have the right from time to time to direct the time, method and place of conducting any proceedings for any remedy available to the Trustee or of exercising any trust or power

conferred upon the Trustee, provided, however, that such direction shall not be otherwise than in accordance with law and the provisions of this Indenture, and the Trustee, subject to the provisions of *Section 9.01*, shall have the right to decline to follow any such direction if the Trustee in good faith shall by a responsible officer or officers (as defined in *Section 8.11*) of the Trustee determine that the proceedings so directed would involve it in personal liability or would be unjustly prejudicial to the Debenture holders not joining in any such direction; and provided further that nothing herein contained shall impair the right of the Trustee in its discretion to take any action deemed proper by the Trustee and which is not inconsistent with such direction by Debenture holders. The holders of a majority in aggregate principal amount of the outstanding Debentures may on behalf of the holders of all of the Debentures waive any past default hereunder and its consequences, provided, however, that any default specified in *subsections (a)* or *(b)* of *Section 8.01* may be waived only if the Company shall have paid or deposited with the Trustee a sum sufficient to pay the principal of all Debentures which shall have matured otherwise than by declaration and all arrears in instalments of interest upon all of the Debentures with interest on any overdue principal and interest, at the rate of 6% per annum, together with all expenses of the Trustee. In the case of any such waiver, the Company, the Trustee and the holders of the Debentures shall be restored to their former positions and rights hereunder, respectively; but no such waiver shall extend to any subsequent or other default, or impair any right consequent thereon. Any such waiver by the holder of a Debenture shall be conclusive and binding upon such holder and upon all future holders thereof, or of any Debenture issued in lieu thereof, irrespective of whether or not any notation of such waiver is made upon the Debenture.

SECTION 8.11. The Trustee shall, within 90 days after the occurrence of a default known to it, give to the Debenture holders, in the manner and to the extent provided in *subsection (c)* of *Section 7.01* with respect to reports pursuant to *subsection (a)* of *Section 7.04*, notice of such default, unless such default shall have been cured before the giving of such notice (the term "default" being hereby defined for the purposes of this *Section 8.11* to be any of the events specified in *subsections (a)* to *(h)*, inclusive, of *Section 8.01* but not including any periods of grace provided in said *subsections* and irrespective of the giving of the written notice specified in

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subsection (d) of *Section 8.01*); provided, however, that in the case of any default of the character specified in *subsection (d)* of *Section 8.01*, no such notice shall be given until at least 60 days after the occurrence thereof; and provided further that, except in the case of default in the payment of any principal, or interest of or on any of the Debentures or in the payment or satisfaction of any sinking fund instalment, the Trustee shall be protected in withholding such notice if and so long as the Board of Directors, the Executive Committee, or a Trust Committee of directors and/or responsible officers of the Trustee in good faith determine that the withholding of such notice is in the interests of the Debenture holders.

The term "responsible officers" of the Trustee as used in this Indenture shall mean and include any of the following: the Chairman of the Board of Directors, the Chairman of the Trust Committee, the President, every Vice-President, every Assistant Vice-President, every Trust Officer, every Assistant Trust Officer, the Secretary, every Assistant Secretary, the Treasurer, and every officer and assistant officer of such Trustee other than those specifically above mentioned, to whom any corporate trust matter is referred because of his knowledge of, and familiarity with, a particular subject.

SECTION 8.12. All parties hereto agree and each holder of any Debenture by his acceptance thereof shall be deemed to have agreed, that any court may in its discretion require, in any suit for the enforcement of any right or remedy under this Indenture or in any suit against the Trustee for any action taken or omitted by it as Trustee, the filing by any party litigant in such suit of an undertaking to pay the costs of such suit, and that such court may in its discretion assess reasonable costs, including reasonable attorney's fees, against any party litigant in such suit, having due regard to the merits and good faith of the claims or defenses made by such party litigant; but the provisions of this *Section 8.12* shall not apply to any suit instituted by the Trustee, to any suit instituted by any Debenture holder, or group of Debenture holders, holding in the aggregate more than 10% in principal amount of the outstanding Debentures, or to any suit instituted by any holder of Debentures for the enforcement of the payment of the principal or interest of or on any Debenture of which he is the holder, on or after the due date expressed in such Debenture.

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ARTICLE IX.

Concerning the Trustee.

SECTION 9.01. The Trustee shall, prior to a default as defined in *Section 8.01*, and after the curing of all of such defaults which may have occurred, perform such duties and only such duties as are specifically set forth herein. In case of such a default, which has not been cured, the Trustee shall exercise such of the rights and powers vested in it hereby, and use the same degree of care and skill in their exercise, as a prudent man would exercise or use under the circumstances in the conduct of his own affairs.

No provision hereof shall be construed to relieve the Trustee from liability for its own negligent action, its own negligent failure to act, or its own willful misconduct, except that:

(a) Prior to such default hereunder and after the curing of all such defaults which may have occurred:

(i) the duties and obligations of the Trustee shall be determined solely by the express provisions hereof and the Trustee shall not be liable except for the performance of such duties and obligations as are specifically set forth herein, and no implied covenants or obligations shall be read into this Indenture against the Trustee; and

(ii) in the absence of bad faith on the part of the Trustee, the Trustee may conclusively rely, as to the truth of the statements and the correctness of the opinions expressed therein, upon any certificates or opinions furnished to the Trustee conforming to the requirements hereof; but in the case of any such certificates or opinions which by the provision of *subsection (b)* of *Section 9.07* are specifically required to be furnished to the Trustee, the Trustee shall be under a duty to examine the same to determine whether or not they conform to the requirements hereof;

(b) At all times, regardless of whether or not any such default shall exist:

(i) the Trustee shall not be liable for any error of judgment made in good faith by a responsible officer or officers (as defined

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in *Section 8.11*) of the Trustee unless it shall be proved that the Trustee was negligent in ascertaining the pertinent facts; and

(ii) the Trustee shall not be liable with respect to any action taken or omitted to be taken by it in good faith in accordance with the direction of the holders of not less than a majority in principal amount of outstanding Debentures relating to the time, method and place of conducting any proceeding for any remedy available to the Trustee, or exercising any trust or power conferred upon the Trustee hereunder.

None of the provisions contained herein shall require the Trustee to expend or risk its own funds or otherwise incur personal financial liability in the performance of any of its duties or in the exercise of any of its rights or powers, if there is reasonable ground for believing that the repayment of such funds or liability is not reasonably assured to it under the terms hereof.

SECTION 9.02. Except as otherwise provided in *Section 9.01:*

(a) The Trustee may rely and shall be protected in acting upon any resolution, certificate, statement, instrument, opinion, report, notice, request, consent, order, Debenture, or other paper or document believed by it to be genuine and to have been signed or presented by the proper party or parties.

(b) Any request, direction, order of demand of the Company mentioned herein shall be sufficiently evidenced by an instrument signed in the name of the Company by the President or any Vice-President and the Secretary or any Assistant Secretary or the Treasurer or any Assistant Treasurer (unless other evidence in respect thereof be herein specifically prescribed); and any resolution of the Board of Directors of the Company may be evidenced to the Trustee by a copy thereof certified by the Secretary or Assistant Secretary of the Company under the corporate seal.

(c) The Trustee may consult with counsel (who may be counsel for the Company), and the opinion of such counsel shall be full and

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complete authorization and protection in respect of any action taken or suffered by it hereunder in good faith and in accordance with the opinion of such counsel.

(d) The Trustee shall be under no obligation to exercise any of the trusts or powers hereof at the request, order or direction of any of the Debenture holders pursuant to the provisions hereof unless such Debenture holders shall have offered to the Trustee reasonable security or indemnity against the costs, expenses and liabilities which may be incurred therein or thereby.

(e) Notwithstanding any provisions hereof authorizing the Trustee conclusively to rely upon any certificate or opinion, the Trustee, may, before taking or refraining from taking any action in reliance thereon, require any further evidence or make any further investigation as to the facts or matters stated therein which it may in good faith deem reasonable in the circumstances; and the Trustee shall require such further evidence or make such further investigation as may reasonably be requested in writing by the holders of a majority in aggregate principal amount of the outstanding Debentures, provided that such Debenture holders shall have offered to the Trustee reasonable security or indemnity against the costs, expenses and liabilities which may be incurred therein or thereby.

SECTION 9.03. The recitals contained herein and in the Debentures, except the Trustee's certificate of authentication and the representations as to the power of the Trustee to enter into this Indenture and to execute the trusts hereby created, shall be taken as the statements of the Company, and the Trustee assumes no responsibility for the correctness of the same. The Trustee makes no representations as to the validity or sufficiency hereof or of the Debentures. The Trustee shall not be accountable for the use or application by the Company of any of the Debentures or of the proceeds of such Debentures.

SECTION 9.04. The Trustee in its individual or any other capacity may become the owner or pledgee of Debentures with the same rights it would have if it were not Trustee.

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SECTION 9.05. Subject to the provisions of *Section 14.02*, all moneys eived by the Trustee shall, until used or applied as herein provided, be d in trust for the purposes for which they were received, but need not segregated from other funds except to the extent required by law. The ustee shall be under no liability for interest on any moneys received by ereunder except such as it may agree with the Company to pay thereon l except as otherwise provided in *Section 6.05*. So long as there shall st no default hereunder in the payment of the principal of or interest the Debentures, all interest allowed on any such moneys shall be paid m time to time upon the written order of the Company, signed by its sident or any Vice-President or its Treasurer or any Assistant Treasurer its Comptroller.

SECTION 9.06. The Company covenants and agrees to pay to the ustee from time to time, and the Trustee shall be entitled to, reasonable mpensation for all services rendered by it in the execution of the trusts reby created and in the exercise and performance of any of the powers d duties hereunder of the Trustee, which compensation shall not be lim- d by any provision of law in regard to the compensation of a trustee of express trust, and the Company will pay or reimburse the Trustee upon request for all expenses, disbursements and advances incurred or made the Trustee in accordance with any of the provisions of this Indenture, cluding the reasonable compensation and the expenses and disbursements its counsel and of all persons not regularly in its employ. If any property her than cash shall at any time be subject to the lien of this Indenture, e Trustee, if and to the extent authorized by a receivership or bank- ptcy court of competent jurisdiction or by the instrument subjecting such operty to such lien, shall be entitled to make advances for the purpose preserving such property or of discharging tax liens or other prior liens encumbrances thereon. The Company also covenants to indemnify the ustee for, and to hold it harmless against, any loss, liability or expense curred without negligence or bad faith on the part of the Trustee, arising t of or in connection with the acceptance or administration of this trust, cluding the costs and expenses of defending itself against any claim of bility in the premises. The obligations of the Company to the Trustee der this *Section 9.06* shall constitute additional indebtedness hereunder. ch additional indebtedness shall be secured by a lien prior to that of the

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Debentures upon all property and funds held or collected by the Trustee as such, except funds held in trust for the benefit of the holders of particular Debentures.

SECTION 9.07. (a) Except as otherwise provided in *Section 9.01*, whenever in the administration of the trusts hereof the Trustee shall deem it necessary or desirable that a matter be proved or established prior to taking or suffering any action hereunder, such matter, unless other evidence in respect thereof be herein specifically prescribed, may, in the absence of bad faith on the part of the Trustee, be deemed to be conclusively proved and established by a certificate signed by the President or any Vice-President and by the Secretary or any Assistant Secretary or the Treasurer or any Assistant Treasurer of the Company and delivered to the Trustee; and such certificate shall be full warrant to the Trustee for any action taken or suffered by it under the provisions hereof upon the faith thereof.

(b) As evidence of compliance with the conditions precedent provided for herein, including any covenants compliance with which constitutes a condition precedent, which relate to the satisfaction and discharge hereof or to any other action to be taken by the Trustee at the request or upon the application of the Company, the Company will furnish to the Trustee a certificate signed as provided in *subsection (a)* of this *Section 9.07* stating that such conditions precedent have been complied with and an opinion of counsel, who may be counsel for the Company, stating that in his opinion such conditions precedent have been complied with.

(c) Each certificate or opinion provided for herein, delivered to the Trustee with respect to compliance with a condition or covenant herein contained, shall include (i) a statement that the person making such certificate or opinion has read such covenant or condition; (ii) a brief statement as to the nature and scope of the examination or investigation upon which the statements or opinions contained in such certificate or opinion are based; (iii) a statement that, in the opinion of such person, he has made such examination or investigation as is necessary to enable him to express an informed opinion as to whether or not such covenant or condition has been complied with; and (iv) a statement as to whether or not, in the opinion of such person, such condition or covenant has been complied with.

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SECTION 9.08. (a) If the Trustee has or acquires any conflicting interest, as defined by *subsection (c)* of this *Section 9.08*, the Trustee shall, within 90 days after ascertaining that it has such conflicting interest, either eliminate such conflicting interest or resign in the manner and with the effect specified in *Section 9.10*.

(b) In the event that the Trustee shall fail to comply with the provisions of *subsection (a)* of this *Section 9.08*, the Trustee shall, within 10 days after the expiration of such 90 day period, transmit notice of such failure to the Debenture holders, in the manner and to the extent provided in *subsection (c)* of *Section 7.04* with respect to reports pursuant to *subsection (a)* of *Section 7.04*.

(c) The Trustee shall, for the purposes of this *Section 9.08*, be deemed to have a conflicting interest if

(i) the Trustee is trustee under another indenture under which any other securities, or certificates of interest or participation in any other securities, of the Company, are outstanding, unless such other indenture is a collateral trust indenture under which the only collateral consists of Debentures isued hereunder, provided that there shall be excluded from the operation of this paragraph and *Section 3.10 (b) (1)* of the Trust Indenture Act of 1939 any indenture under which other securities, or certificates of interest or participation in other securities, of the Company, are outstanding if (1) this Indenture and such other indenture are wholly unsecured and such other indenture is hereafter qualified under the Trust Indenture Act of 1939, unless the Securities and Exchange Commission shall have found and declared by order pursuant to subsection (b) of Section 305 or subsection (c) of Section 307 of the Trust Indenture Act of 1939 that differences exist between the provisions hereof and the provisions of such other indenture which are so likely to involve a material conflict of interest as to make it necessary in the public interest or for the protection of investors to disqualify the Trustee from acting as such hereunder or under such other indenture, or (2) the Company shall have sustained the burden or proving, on application to the Securities and Exchange Commission and after opportunity for hearing thereon, that trusteeship hereunder and under such other indenture is not so likely to involve a material

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conflict of interest as to make it necessary in the public interest or for the protection of investors to disqualify the Trustee from acting as such hereunder or under such other indenture;

(ii) the Trustee or any of its directors or executive officers is an obligor upon the Debentures or an underwriter for the Company;

(iii) the Trustee directly or indirectly controls or is directly or indirectly controlled by or is under direct or indirect common control with the Company or an underwriter for the Company;

(iv) the Trustee or any of its directors or executive officers is a director, officer, partner, employee, appointee, or representative of the Company, or of an underwriter (other than the Trustee itself) for the Company who is currently engaged in the business of underwriting, except that (1) 1 individual may be a director and/or an executive officer of the Trustee and a director and/or executive officer of the Company, but may not be at the same time an executive officer of both the Trustee and the Company; (2) if and so long as the number of directors of the Trustee in office is more than 9, one additional individual may be a director and/or an executive officer of the Trustee and a director of the Company; and (3) the Trustee may be designated by the Company or by any underwriter for the Company to act in the capacity of transfer agent, registrar, custodian, paying agent, fiscal agent, escrow agent or depositary, or in any other similar capacity, or, subject to the provisions of *paragraph (i)* of this *subsection (c)*, to act as trustee whether under an indenture or otherwise;

(v) 10% or more of the voting securities of the Trustee is beneficially owned either by the Company or by any director, partner or executive officer thereof, or 20% or more of such voting securities is beneficially owned, collectively, by any 2 or more of such persons; or 10% or more of the voting securities of the Trustee is beneficially owned either by an underwriter for the Company or by any director, partner or executive officer thereof, or is beneficially owned, collectively, by any 2 or more such persons;

(vi) the Trustee is the beneficial owner of, or holds as collateral security for an obligation which is in default, (1) 5% or more of the

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voting securities or 10% or more of any other class of security of the Company, not including the Debentures and securities issued under any other indenture under which the Trustee is also trustee, or (2) 10% or more of any class of security of an underwriter for the Company;

(vii) the Trustee is the beneficial owner of, or holds as collateral security for an obligation which is in default, 5% or more of the voting securities of any person who, to the knowledge of the Trustee, owns 10% or more of the voting securities of, or controls directly or indirectly or is under direct or indirect common control with, the Company;

(viii) the Trustee is the beneficial owner of, or holds as collateral security for an obligation which is in default, 10% or more of any class of security of any person who, to the knowledge of the Trustee, holds 50% or more of the voting securities of the Company; or

(ix) The Trustee owns on May 15 in any calendar year in the capacity of executor, administrator, testmentary or inter vivos trustee, guardian, committee or conservator, or in any other similar capacity, an aggregate of 25% or more of the voting securities, or of any class of security, of any person, the beneficial ownership of a specified percentage of which would have constituted a conflicting interest under *paragraphs (vi), (vii)* or *viii* of this *subsection (c)*. As to any such securities of which the Trustee acquired ownership through becoming executor, administrator or testmentary trustee of an estate which included them, the provisions of the preceding sentence shall not apply for a period of 2 years from the date of such acquisition, to the extent that such securities included in such estate do not exceed 25% of such voting securities or 25% of any such class of security. On May 15 in each calendar year the Trustee shall make a check of its holdings of such securities in any of the above-mentioned capacities as of such May 15. If the Company fails to make payment in full of principal or interest upon any of the Debentures when and as the same become due and payable, and such failure continues for 30 days thereafter, the Trustee shall make a prompt check of its holdings of such securities in any of the above-mentioned capacities as of the date of the expiration of such 30 day period, and after such date, notwithstanding the foregoing provisions of this paragraph, all such se-

curities so held by the Trustee, with sole or joint control over s
securities vested in it, shall, but only so long as such failure shall c
time, be considered as though beneficially owned by the Trustee
the purposes of *paragraphs (vi), (vii)* and *(viii)* of this *subsection*

The specifications of percentages in *paragraphs (v)* to *(ix)*, inclus
of this *subsection (c)* shall not be construed as indicating that the ow
ship of such percentages of the securities of a person is or is not neces
or sufficient to constitute direct or indirect control for the purposes of p
graph (iii) or (vii) of this subsection (c).

For the purposes of *paragraphs (vi), (vii), (viii)* and *(ix)* of this *sub*
tion (c) only, (1) the terms "security" and "securities" shall include
such securities as are generally known as corporate securities, but shall
include any note or other evidence of indebtedness issued to evidence
obligation to repay moneys lent to a person by one of more banks, t
companies or banking firms or any certificate of interest or participatio
any such note or evidence of indebtedness; (2) an obligation shall
deemed to be in default when a default in payment of principal shall h
continued for 30 days or more and shall not have been cured; and (3)
Trustee shall not be deemed to be the owner or holder of (A) any secu
which it holds as collateral security, as trustee or otherwise, for an obl
tion which is not in default as in this paragraph defined, or (B) any se
ity which it holds as collateral security under this Indenture, irrespec
of any default hereunder, or (C) any security which it holds as agent
collection, or as custodian, escrow agent or depositary, or in any sim
representative capacity.

Except as above provided, the word "security" or "securities" as u
in this Indenture shall mean any note, stock, treasury stock, bond, deb
ture, evidence of indebtedness, certificate of interest or participation in
profit-sharing agreement, collateral-trust certificate, pre-organization
tificate or subscription, transferable share, investment contract, voting t
certificate, certificate of deposit for a security, fractional undivided inte
in oil, gas, or other mineral rights, or, in general, any interest or instrum
commonly known as a "security," or any certificate of interest or partici
tion in, temporary or interim certificate for, receipt for, guarantee of,
warrant or right to subscribe to or purchase, any of the foregoing.

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(d) For the purposes of this *Section 9.08*:

(i) The term "underwriter" when used with reference to the Company shall mean every person who, within 3 years prior to the time as of which the determination is made, has purchased from the Company with a view to, or has sold for the Company in connection with, the distribution of any security of the Company outstanding at such time, or has participated or has had a direct or indirect participation in any such undertaking, or has participated or has had a participation in the direct or indirect underwriting of any such undertaking, but such term shall not include a person whose interest was limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission.

(ii) The term "director" shall mean any director of a corporation or any individual performing similar functions with respect to any organization whether incorporated or unincorporated.

(iii) The term "person" shall mean an individual, a corporation, a partnership, an association, a joint stock company, a trust, an unincorporated organization, or a government or political subdivision thereof. As used in this paragraph, the term "trust" shall include only a trust where the interest or interests of the beneficiary or beneficiaries are evidenced by a security.

(iv) The term "voting security" shall mean any security presently entitling the owner or holder thereof to vote in the direction or management of the affairs of a person, or any security issued under or pursuant to any trust, agreement or arrangement whereby a trustee or trustees or agent or agents for the owner or holder of such security are presently entitled to vote in the direction or management of the affairs of a person.

(v) The term "Company" shall mean any obligor upon the Debentures.

(vi) The term "executive officer" shall mean the president, every vice-president, every trust officer, the cashier, the secretary and the treasurer of a corporation, and any individual customarily performing

similar functions with respect to any organization whether incorp ated or unincorporated, but shall not include the chairman of t Board of Directors.

(vii) The percentages of voting securities and other securit shall be calculated in accordance with the following provisions:

(1) A specified percentage of the voting securities of a pers means such amount of the outstanding voting securities of su person as entitles the holder or holders thereof to cast such spe fied percentage of the aggregate votes which the holders of all t outstanding voting securities of such person are entitled to c in the direction or management of the affairs of such person.

(2) A specified percentage of a class of securities of a pers means such percentage of the aggregate amount of securities the class outstanding.

(3) The term "amount," when used in regard to securiti means the principal amount if relating to evidences of indebt ness, the number of shares if relating to capital shares, and t number of units if relating to any other kind of security.

(4) The term "outstanding" means issued and not held by for the account of the issuer. The following securities shall n be deemed outstanding within the meaning of this definition:

(A) Securities of an issuer held in a sinking fund relati to securities of the issuer of the same class;

(B) Securities of an issuer held in a sinking fund relati to another class of securities of the issuer, if the obligati evidenced by such other class of securities is not in default to principal or interest or otherwise;

(C) Securities pledged by the issuer thereof as secur for an obligation of the issuer not in default as to princi or interest or otherwise;

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(D) Securities held in escrow if placed in escrow by the issuer thereof;

provided, however, that any voting securities of an issuer shall be deemed outstanding if any person other than the issuer is entitled to exercise the voting rights thereof.

(5) A security shall be deemed to be of the same class as another security if both securities confer upon the holder or holders thereof substantially the same rights and privileges, provided, however, that in the case of secured evidences of indebtedness, all of which are issued under a single indenture, differences in the interest rates or maturity dates of various series thereof shall not be deemed sufficient to constitute such series different classes, and provided further that, in the case of unsecured evidences of indebtedness, differences in the interest rates or maturity dates thereof shall not be deemed sufficient to constitute them securities of different classes, whether or not they are issued under a single indenture.

SECTION 9.09. There shall at all times be a trustee hereunder which shall be a corporation and shall be a national banking association organized and existing under the laws of the United States of America or a bank or trust company organized and existing under the laws of any State or Territory thereof or of the District of Columbia, authorized under such laws to exercise corporate trust powers, having its principal office in the city of Newark, New Jersey, New York, New York, or Philadelphia, Pennsylvania, having a combined capital and surplus of at least $5,000,000, and subject to supervision or examination by Federal, State, Territorial or District of Columbia authority. If such national banking association or bank or trust company publishes reports of condition at least annually, pursuant to law or to the requirements of any supervising or examining authority above referred to, then for the purposes of this *Section 9.09* the combined capital and surplus of such national banking association or bank or trust company shall be deemed to be its combined capital and surplus as set forth in its most recent report of condition so published. In case at any time the Trustee shall cease to be eligible in accordance with the provisions of this

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Section 9.09, the Trustee shall resign immediately in the manner and wi
the effect specified in *Section 9.10*.

SECTION 9.10. (a) The Trustee may at any time resign by givi
written notice to the Company and by giving to the Debenture holde
notice by publication of such resignation, which notice shall be publish
at least once in a New York Daily Newspaper. Upon receiving such noti
of resignation, the Company shall promptly appoint a successor trust
If no successor trustee shall have been so appointed and have accept
appointment within 30 days after publication of such notice of resignatio
the resigning Trustee may petition any court of competent jurisdiction f
the appointment of a successor trustee, or, subject to the provisions
Section 8.12, any Debenture holder who has been a bona fide holder o
Debenture for at least 6 months may, on behalf of himself and all oth
similarly situated, petition any such court for the appointment of a succ
sor trustee. Such court may thereupon after such notice, if any, as it m
deem proper and prescribe, appoint a successor trustee.

(b) In case at any time any of the following shall occur:

(i) the Trustee shall fail to comply with the provisions of *subs*
tion (a) of *Section 9.08* after written request therefor by the Compa
or by any Debenture holder who has been a bona fide holder o
Debenture for at least 6 months, or

(ii) the Trustee shall cease to be eligible in accordance with t
provisions of *Section 9.09* and shall fail to resign after written requ
therefor by the Company or by any such Debenture holder, or

(iii) the Trustee shall become incapable of acting, or shall
adjudged a bankrupt or insolvent, or a receiver of the Trustee or of
property shall be appointed, or any public officer shall take charge
control of the Trustee or of its property or affairs for the purpose
rehabilitation, conservation or liquidation,

then, in any such case, the Company may remove the Trustee and appo
a successor trustee, or, subject to the provisions of *Section 8.12*, any su
Debenture holder may, on behalf of himself and all others similarly si
ated, petition any court of competent jurisdiction for the removal of t
Trustee and the appointment of a successor trustee. Such court may the

upon, after such notice, if any, as it may deem proper and prescribe, remove the Trustee and appoint a successor trustee.

(c) The holders of a majority in aggregate principal amount of the outstanding Debentures may at any time remove the Trustee and appoint a successor trustee.

(d) Any resignation or removal of the Trustee and appointment of a successor trustee pursuant to any of the provisions of this *Section 9.10* shall become effective upon acceptance of appointment by the successor trustee as provided in *Section 9.11*.

SECTION 9.11. Any successor trustee appointed as provided in *Section 9.10* shall execute, acknowledge and deliver to the Company and to its predecessor trustee an instrument accepting such appointment hereunder, and thereupon the resignation or removal of the predecessor trustee shall become effective and such successor trustee, without any further act, deed or conveyance, shall become vested with all the rights, powers, trusts, duties and obligations of its predecessor in the trusts hereunder, with like effect as if originally named as trustee herein; but, nevertheless, on the written request of the Company or of the successor trustee, the trustee ceasing to act shall execute and deliver an instrument transferring to such successor trustee, upon the trusts herein expressed, all the rights, powers and trusts of the trustee so ceasing to act. Upon request of any such successor trustee, the Company shall execute any and all instruments in writing for more fully and certainly vesting in and confirming to such successor trustee all such rights, powers and duties. Any trustee ceasing to act shall, nevertheless, retain a lien upon all property or funds held or collected by such trustee to secure the amounts due it as compensation, reimbursement, expenses and indemnity afforded to it by *Section 9.06*.

No successor trustee shall accept appointment as provided in this *Section 9.11*, unless at the time of such acceptance such successor trustee shall be qualified under the provisions of *Section 9.08* and eligible under the provisions of *Section 9.09*.

Upon acceptance of appointment by a successor trustee as provided in this *Section 9.11*, the Company shall publish notice of the succession of such trustee to the trusts hereunder at least once in a New York Daily

Newspaper. If the Company fails to publish such notice within 10 days after acceptance of appointment by the successor trustee, the successor trustee shall cause such notice to be published at the expense of the Company.

SECTION 9.12. Any corporation into which the Trustee may be merged or with which it may be consolidated, or any corporation resulting from any merger or consolidation to which the Trustee shall be a party, or any corporation succeeding to the business of the Trustee, shall be the successor of the Trustee hereunder without the execution or filing of any paper or any further act on the part of any of the parties hereto, anything herein to the contrary notwithstanding, providing that such successor trustee shall be eligible under the provisions of *Section 9.09* and that, if such successor trustee shall not be qualified under the provisions of *Section 9.08*, such successor trustee shall, within 90 days after becoming such successor trustee, either become qualified under the provisions of *Section 9.08* or resign in the manner and with the effect specified in *Section 9.10*.

SECTION 9.13. (a) Subject to the provisions of *subsection (b)* of this *Section 9.13*, if the Trustee shall be or shall become a creditor, directly or indirectly, secured or unsecured, of the Company within 4 months prior to a default (as defined in *subsection (c)* of this *Section 9.13*) or subsequent to such default, then, unless and until such default shall be cured, the Trustee shall set apart and hold in a special account for the benefit of the Trustee individually, the holders of the Debentures and the holders of other indenture securities (as defined in *subsection (c)* of this *Section 9.13*)

(i) an amount equal to any and all reductions in the amount due and owing upon any claim as such creditor in respect of principal or interest, effected after the beginning of such 4 months' period and valid as against the Company and its other creditors, except any such reduction resulting from the receipt or disposition of any property described in *paragraph (ii)* of this *subsection (a)* or from the exercise of any right of set-off which the Trustee could have exercised if a petition in bankruptcy had been filed by or against the Company upon the date of such default; and

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(ii) all property received in respect of any claim as such creditor, either as security therefor, or in satisfaction or composition thereof, or otherwise, after the beginning of such 4 months' period, or an amount equal to the proceeds of any such property, if disposed of, subject, however, to the rights, if any, of the Company and its other creditors in such property or such proceeds.

Nothing herein contained, however, shall affect the right of the Trustee

(1) to retain for its own account (A) payments made on account of any such claim by any person (other than the Company) who is liable thereon, and (B) the proceeds of the bona fide sale of any such claim by the Trustee to a third person, and (C) distributions made in cash, securities, or other property in respect of claims filed against the Company in bankruptcy or receivership or in proceedings for reorganization pursuant to the Federal bankruptcy laws or applicable State law;

(2) to realize for its own account upon any property held by it as security for any such claim, if such property was so held prior to the beginning of such 4 months' period;

(3) to realize for its own account, but only to the extent of the claim hereinafter mentioned, upon any property held by it as security for any such claim, if such claim was created after the beginning of such 4 months' period and such property was received as security therefor simultaneously with the creation thereof, and if the Trustee shall sustain the burden of proving that at the time such property was so received the Trustee had no reasonable cause to believe that a default as defined in *subsection (c)* of this *Section 9.13* would occur within 4 months; or

(4) to receive payment on any claim referred to in *paragraph (2)* or *(3)* next preceding, against the release of any property held as security for such claim as provided in said *paragraph (2)* or *(3)*, as the case may be, to the extent of the fair value of such property.

For the purposes of *paragraphs (2), (3)* and *(4)* next preceding, property substituted after the beginning of such 4 months' period for property held as security at the time of such substitution shall, to the extent of the fair

value of the property released, have the same status as the property released, and, to the extent that any claim referred to in any of such paragraphs is created in renewal of or in substitution for or for the purpose of repaying or refunding any pre-existing claim of the Trustee as such creditor, such claim shall have the same status as such pre-existing claim.

If the Trustee shall be required to account, the funds and property held in such special account and the proceeds thereof shall be apportioned between the Trustee, the Debenture holders, and the holders of other indenture securities, in such manner that the Trustee, the Debenture holders, and the holders of other indenture securities realize, as a result of payments from such special account and payments of dividends on claims filed against the Company in bankruptcy or receivership or in proceedings for reorganization pursuant to the Federal bankruptcy laws or applicable State law, the same percentage of their respective claims, figured before crediting to the claim of the Trustee anything on account of the receipt by it from the Company of the funds and property in such special account and before crediting to the respective claims of the Trustee, the Debenture holders, and the holders of other indenture securities, dividends on claims filed against the Company in bankruptcy or receivership or in proceedings for reorganization pursuant to the Federal bankruptcy laws or applicable State law, but after crediting thereon receipts on account of the indebtedness represented by their respective claims from all sources other than from such dividends and from the funds and property so held in such special account. As used in this paragraph, with respect to any claim, the term "dividends" shall include any distribution with respect to such claim in bankruptcy or receivership or in proceedings for reorganization pursuant to the Federal bankruptcy laws or applicable State law, whether such distribution is made in cash, securities, or other property, but shall not include any such distribution with respect to the secured portion, if any, of such claim. The court in which such bankruptcy, receivership, or proceedings for reorganization is pending shall have jurisdiction (A) to apportion between the Trustee, the Debenture holders and holders of other indenture securities, in accordance with the provisions of this paragraph, the funds and property held in such special account and the proceeds thereof, or (B) in lieu of such apportionment, in whole or in part, to give to the provisions of this paragraph due consideration in determining the fairness

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of the distributions to be made to the Trustee, the Debenture holders, and the holders of other indenture securities, with respect to their respective claims, in which event it shall not be necessary to liquidate or to appraise the value of any securities or other property held in such special account or as security for any such claim, or to make a specific allocation of such distributions as between the secured and unsecured portions of such claims, or otherwise to apply the provisions of this paragraph as a mathematical formula.

Any Trustee who has resigned or been removed after the beginning of such 4 months' period shall be subject to the provisions of this *subsection (a)* as though such resignation or removal had not occurred. If any Trustee has resigned or been removed prior to the beginning of such 4 months' period, it shall be subject to the provisions of this *subsection (a)* if and only if the following conditions exist—

(A) the receipt of property or reduction of claim which would have given rise to the obligation to account, if such Trustee had continued as trustee, occurred after the beginning of such 4 months' period; and

(B) such receipt of property or reduction of claim occurred within 4 months after such resignation or removal.

(b) There shall be excluded from the operation of *subsection (a)* of this *Section 9.13* a creditor relationship arising from—

(i) the ownership or acquisition of securities issued under any indenture, or any security or securities having a maturity of 1 year or more at the time of acquisition by the Trustee;

(ii) if any property other than cash shall at any time be subject to the lien of this Indenture, advances authorized by a receivership or bankruptcy court of competent jurisdiction or by the instrument subjecting such property to such lien, made for the purpose of preserving such property or of discharging tax liens or other prior liens or encumbrances thereon, if notice of such advance and of the circumstances surrounding the making thereof is given to the Debenture holders as provided in *subsections (a), (b)* and *(c) of Section 7.04* with respect to advances by the Trustee as such;

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(iii) disbursements made in the ordinary course of business in the capacity of trustee under an indenture, transfer agent, registrar, custodian, paying agent, fiscal agent or depositary, or other similar capacity;

(iv) an indebtedness created as a result of services rendered or premises rented; or an indebtedness created as a result of goods or securities sold in a cash transaction as defined in *subsection (c)* of this *Section 9.13;*

(v) the ownership of stock or of other securities of a corporation organized under the provisions of Section 25 (a) of the Federal Reserve Act, as amended, which is directly or indirectly a creditor of the Company; or

(vi) the acquisition, ownership, acceptance or negotiation of any drafts, bills of exchange, acceptances or obligations which fall within the classification of self-liquidating paper as defined in *subsection (c)* of this *Section 9.13.*

(c) As used in this *Section 9.13:*

(i) The term "default" shall mean any failure to make payment in full of the principal of or interest upon any of the Debentures or upon any other indenture securities when and as such principal or interest becomes due and payable.

(ii) The term "other indenture securities" shall mean securities upon which the Company is an obligor (as defined in the Trust Indenture Act of 1939) outstanding under any other indenture (1) under which the Trustee is also trustee, (2) which contains provisions substantially similar to the provisions of *subsection (a)* of this *Section 9.13* and (3) under which a default exists at the time of the apportionment of the funds and property held in said special account.

(iii) The term "cash transaction" shall mean any transaction in which full payment for goods or securities sold is made within 7 days after delivery of the goods or securities in currency or in checks or other orders drawn upon banks or bankers and payable upon demand.

(iv) The term "self-liquidating paper" shall mean any draft, bill of exchange, acceptance or obligation which is made, drawn, negoti-

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ated or incurred by the Company for the purpose of financing the purchase, processing, manufacture, shipment, storage or sale of goods, wares or merchandise and which is secured by documents evidencing title to, possession of, or a lien upon, the goods, wares or merchandise or the receivables or proceeds arising from the sale of the goods, wares or merchandise previously constituting the security, provided the security is received by the Trustee simultaneously with the creation of the creditor relationship with the Company arising from the making, drawing, negotiating or incurring of the draft, bill of exchange, acceptance or obligation.

(v) The term "Company" shall include any obligor upon the Debentures.

ARTICLE X.

Concerning the Debenture Holders.

SECTION 10.01. Wherever it is provided herein that the holders of a specified percentage in aggregate principal amount of Debentures may take any action (including the making of any demand or request, the giving of any notice or consent or the taking of any other action) the fact that at the time of taking any such action the holders of such specified percentage have joined therein may be evidenced (a) by any instrument or any number of instruments of similar tenor executed by Debenture holders, in person or by agent or proxy appointed in writing, or (b) by the record of the holders of Debentures voting in favor thereof at any meeting of Debenture holders duly called and held in accordance with the provisions of *Article XI*, or (c) by a combination of such instrument or instruments and any such record of such a meeting of Debenture holders; but in each case only to the extent that the holders of Debentures shall not have revoked such action, consent or vote pursuant to *Section 10.05*.

SECTION 10.02. Subject to the provisions of *Section 9.01*, proof of the execution of any instrument by a Debenture holder or his agent or proxy, and proof of the holding by any person of any of the Debentures, shall be sufficient for any purpose of this Indenture, if made in the following manner:

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The fact and date of the execution by any such person of any ins ment may be proved by the certificate of any notary public, or other off authorized to take acknowledgments of deeds to be recorded within United States of America, that the person executing such instrument knowledged to him the execution thereof, or by an affidavit of a witnes such execution sworn to before any such notary or other such offi

The holding of Debentures registered as to principal at the time determination of the holders of Debentures for any purpose of this Ind ture shall be proved by the register of such Debentures or by a certific of the registrar thereof.

The record of any Debenture holders' meeting shall be proved in manner provided in *Section 11.06*.

The Trustee may require such additional proof of any matter refer to in this *Section 10.02* as it shall deem necessary.

SECTION 10.03. The Company and the Trustee may deem and tr the person in whose name any Debenture shall be registered upon books of the Company as hereinbefore provided as the absolute ow thereof, whether or not the same shall be overdue, for the purpose of ceiving payment of or on account of the principal of and interest on s Debenture, and for all other purposes. All such payments so made to upon the order of any such registered holder shall be valid, and, to extent of the sum or sums so paid, effectual to satisfy the liability moneys payable upon any such Debenture.

SECTION 10.04. In determining whether the holders of the requi aggregate principal amount of Debentures have concurred in any direct or consent hereunder, Debentures which are owned by the Company by any other obligor on the Debentures or by any person directly or directly controlling or controlled by or under direct or indirect comm control with the Company or any such other obligor shall be disregar and deemed not to be outstanding for the purpose of such determinat except that for the purposes of determining whether the Trustee shall relieved of liability in relying on any such direction or consent, only Del tures which the Trustee knows to be so owned shall be so disregarded

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SECTION 10.05. At any time prior to the evidencing to the Trustee, as provided in *Section 10.01*, of the taking of any action by the holders of the percentage in aggregate principal amount of the Debentures specified in this Indenture in connection with such action, any holder of a Debenture, the serial number of which is shown by the evidence to be included in the Debentures the holders of which have consented to or voted in favor of such action may, by filing written notice with the Trustee at its principal office and upon proof of holding as provided in *Section 10.02*, revoke such action, consent or vote so far as concerns such Debenture. Except as aforesaid, any such action taken by the holder of any Debenture shall be conclusive and binding upon such holder and upon all future holders of such Debenture, irrespective of whether or not any notation of such consent is made upon such Debenture, and in any event any action taken by the holders of the percentage in aggregate principal amount of the Debentures specified herein in connection with such action shall be conclusively binding upon the Company, the Trustee and the holders of all Debentures.

ARTICLE XI.

Debenture Holders' Meetings.

SECTION 11.01. A meeting of holders of outstanding Debentures may be called at any time and from time to time pursuant to the provisions of this *Article XI* for any of the following purposes:

(a) to give any notice to the Company or to the Trustee, or to give any directions to the Trustee, or to consent to the waiving of any default hereunder and its consequences, or to take any other action authorized to be taken by Debenture holders pursuant to any of the provisions hereof;

(b) to remove the Trustee and appoint a successor trustee pursuant to the provisions of *Section 9.10*.

(c) to consent to the execution of any indenture supplemental hereto pursuant to the provisions of *Section 12.02;* or

(d) to take any other action authorized to be taken by or on behalf of the holders of any specified aggregate principal amount of the Debentures under any other provision hereof or under applicable law.

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SECTION 11.02. The Trustee may at any time call a meeting of the holders of outstanding Debentures to take any action specified in *Section 11.01*, to be held at such time and at such place in the City of Philadelphia, Pennsylvania, or Lamar, Colorado, as the Trustee shall determine. Notice of every meeting of Debenture holders setting forth the time and the place of such meeting and the purpose of such meeting in reasonable detail shall be published once in each calendar week (in each case on any business day of the week) for at least 4 successive weeks in a New York Daily Newspaper (which need not be the same newspaper for all such publications), the first publication to be not less than 20 nor more than 180 days prior to the date fixed for the meeting; and on or before the date of the first publication of such notice the Trustee shall also mail a copy thereof to the Company and to each registered holder of a Debenture at the last address of such holder appearing on the register provided for in *Section 2.04*, but failure to so mail or any defect therein shall not affect the validity of the meeting.

SECTION 11.03. In case at any time the Company, pursuant to a resolution of its Board of Directors, or the holders of 20% in aggregate principal amount of the outstanding Debentures, shall have requested the Trustee to call a meeting of the Debenture holders by written request setting forth in reasonable detail the purpose of the meeting, and the Trustee shall not have made the first publication of the notice of such meeting within 20 days after receipt of such request, then the Company or the holders of Debentures in the amount above specified, whichever shall have made such request, may determine the time and place for such meeting and may call such meeting to take any action authorized in *Section 11.01*, by giving notice thereof as provided in *Section 11.02*.

SECTION 11.04. To be entitled to vote at any meeting of Debenture holders, a person shall (a) be a registered holder of Debentures registered as to principal, or (b) be a person appointed by an instrument in writing as proxy by any such holder. The only persons who shall be entitled to be present or to speak at any meeting of Debenture holders shall be the persons entitled to vote at such meeting and their counsel, the inspectors of votes, and any representatives of the Trustee and its counsel and any representatives of the Company and its counsel.

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SECTION 11.05. Notwithstanding any other provisions of this Indenture, the Trustee, may make such reasonable regulations as it may deem advisable for any meeting of Debenture holders, in regard to proof of the holding of Debentures, the appointment of proxies, the appointment and duties of inspectors of votes, the submission and examination of proxies, certificates and other evidences of the right to vote, and such other matters concerning the conduct of the meeting as it shall think fit. Except as otherwise permitted or required by any such regulations, the holding of Debentures shall be proved in the manner specified in *Section 10.02* and the appointment of any proxy shall be proved in the manner specified in *Section 10.02* or by having the signature of the person executing the proxy witnessed or guaranteed by any bank, banker or trust company authorized by *Section 10.02* to so guarantee.

The Trustee shall, by an instrument in writing, appoint a temporary chairman of the meeting, unless the meeting shall have been called by the Company or by Debenture holders as provided in *Section 11.03*, in which case the Company or the Debenture holders calling the meeting, as the case may be, shall in like manner appoint a temporary chairman. The meeting shall elect a permanent chairman and a permanent secretary of the meeting.

Subject to the provisions of *Section 10.04*, at any meeting each Debenture holder or proxy shall be entitled to 1 vote for every $50 principal amount of Debentures held or represented by him, provided, however, that no vote shall be cast or counted at any meeting in respect of any Debenture challenged as not outstanding and ruled by the chairman of the meeting to be not outstanding. The chairman of the meeting shall have no right to vote other than by virtue of Debentures held by him or instruments in writing as aforesaid duly designating him as the person to vote on behalf of other Debenture holders. Any meeting of Debenture holders duly called pursuant to the provisions of this *Article XI* may be adjourned from time to time for a period or periods not to exceed in the aggregate 1 year from the date for which the meeting shall have originally been called, and the meeting may be held as so adjourned without further notice.

SECTION 11.06. The vote upon any proposal submitted in accordance with the provisions of *Section 11.01* shall be by written ballots on which

shall be subscribed the signatures of the Debenture holders or their representatives by proxy and the serial number or numbers of the Debentures held or represented by them. The chairman of the meeting shall appoint 2 inspectors of votes who shall count all votes cast at the meeting for or against any proposal and who shall make and file with the secretary of the meeting their verified written reports in duplicate of all votes cast at the meeting which reports shall show the serial numbers of all Debentures voting in favor of any such proposal. A record in duplicate of the proceedings of each meeting of the Debenture holders shall be prepared by the secretary of the meeting and there shall be attached to said record the original reports of the inspectors of votes on any vote by ballot taken thereat and affidavits by one or more persons having knowledge of the facts setting forth a copy of the notice of the meeting and showing that said notice was given as provided in *Section 11.02*. The record shall be signed and verified by the affidavits of the permanent chairman and secretary of the meeting and one of the duplicates shall be delivered to the Company and the other to the Trustee to be preserved by the Trustee. Any record so signed and verified and the reports of the inspectors and the affidavits attached thereto shall be conclusive evidence of the matters therein stated.

SECTION 11.07. Nothing in this *Article XI* contained shall be deemed or construed to authorize or permit, by reason of any call of a meeting of Debenture holders or any rights expressly or impliedly conferred hereunder to make such call, any hindrance or delay in the exercise of any right or rights conferred upon or reserved to the Trustee or to the Debenture holders under any of the provisions hereof or of the Debentures.

ARTICLE XII.

Supplemental Indentures.

SECTION 12.01. The Company, when authorized by a resolution of its Board of Directors, and the Trustee may, from time to time and at any time, enter into an indenture or indentures supplemental hereto for one or more of the following purposes:

(a) To add to the covenants of the Company such further covenants as its Board of Directors and the Trustee shall consider to be for

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the protection of the holders of Debentures, and to make the occurrence and continuance of failure to perform any of such additional covenants a default permitting the enforcement of all or any of the several remedies provided for herein; provided, however, that in respect of any such additional covenant, such supplemental indenture may provide for a particular period of grace (which period may be shorter or longer than that allowed in the case of other defaults), or for an immediate enforcement, upon such default, or may limit the remedies which may become available to the Trustee on account of such default, or may limit the right of the holders of a majority in aggregate principal amount of the Debentures to waive such default.

(b) To evidence the succession or successive successions of any other corporation or corporations to the Company and the assumption by such successor corporation or corporations of the covenants and obligations of the Company hereunder.

(c) To mortgage, pledge, convey, assign and transfer to the Trustee any property or assets as security for the Debentures, and to specify the terms and conditions upon which such property or assets are to be held and dealt with by the Trustee, and to set forth such other provisions in respect thereof as may be required hereby or as may, consistent with the provisions hereof, be deemed appropriate by the Company and the Trustee, or to correct or amplify the description of any such property or assets at any time so mortgaged, pledged, conveyed, assigned and transferred to the Trustee.

(d) To cure any ambiguity or to correct or supplement any provision hereof which may be defective or inconsistent with any other provision hereof, or to make such other provisions in regard to matters or questions arising hereunder as the Board of Directors of the Company may deem necessary or desirable and which shall not be inconsistent with provisions hereof and which shall not adversely affect the interests of the Debenture holders.

The Trustee is hereby authorized to join with the Company in the execution of any such supplemental indenture, to make any further appropriate agreements and stipulations which may be therein contained and to accept the conveyance, transfer and assignment of any property thereun-

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der, but the Trustee shall not be obligated to enter into any such supplemental indenture which affects the Trustee's own rights, duties or immunities hereunder or otherwise.

Any supplemental indenture authorized by the provisions of this *Section 12.01* may be executed by the Company and the Trustee without the consent of the holders of any of the Debentures at the time outstanding, notwithstanding any of the provisions of *Section 12.02*.

SECTION 12.02. With the consent, evidenced as provided in *Section 10.01*, of the holders of not less than 66⅔% in aggregate principal amount of the outstanding Debentures, the Company, when authorized by a resolution of its Board of Directors, and the Trustee may, from time to time and at any time, enter into any indenture supplemental hereto for the purpose of adding any provisions to, or changing in any manner or eliminating any of the provisions hereof; provided, however, that no such supplemental indenture shall (a) extend the fixed maturity of any of the Debentures, or reduce the rate or extend the time of payment of interest thereon, or reduce the amount of the principal thereof without the consent of the holder of each Debenture so affected, or (b) reduce the aforesaid percentage of Debentures, the consent of the holders of which is required to approve any such supplemental indenture, without the consent of the holders of all the outstanding Debentures. Upon the request of the Company, accompanied by a copy of a resolution of its Board of Directors certified by the Secretary or any Assistant Secretary of the Company authorizing the execution of any such supplemental indenture, and upon the filing with the Trustee of evidence of the consent of Debenture holders as aforesaid, the Trustee shall join with the Company in the execution of such supplemental indenture unless such supplemental indenture affects the Trustee's own rights, duties or immunities hereunder or otherwise, in which case the Trustee may in its discretion, but shall not be obligated to, enter into such supplemental indenture.

It shall not be necessary for the consent of the Debenture holders under this *Section 12.02* to approve the particular form of any proposed supplemental indenture, but it shall be sufficient if such consent shall approve the substance thereof.

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Promptly after the execution by the Company and the Trustee of any supplemental indenture pursuant to the provisions of this *Section 12.02*, the Company shall publish a notice, setting forth in general terms the substance of such supplemental indenture, at least once in a New York Daily Newspaper and shall also mail a copy thereof to each registered holder of a Debenture at the last address of such holder appearing on the register provided for in *Section 2.04*. Any failure of the Company to give such notice, or any defect therein, shall not, however, in any way impair or affect the validity of any such supplemental indenture.

SECTION 12.03. Any supplemental indenture executed pursuant to the provisions of this *Article XII* shall comply with the provisions of the Trust Indenture Act of 1939 as then in effect. Upon the execution of any supplemental indenture pursuant to the provisions of this *Article XII*, this Indenture shall be and be deemed to be modified and amended in accordance therewith and the respective rights, duties and obligations hereunder the Company, the Trustee and all holders of Debentures shall thereafter be determined, exercised and enforced hereunder subject in all respects to such modifications or amendments, and all the terms and conditions of any such supplemental indenture shall be and be deemed to be part of the terms and conditions hereof for any and all purposes.

SECTION 12.04. The Trustee, subject to the provisions of *Section 9.01*, may receive an opinion of counsel, who may be counsel for the Company, as conclusive evidence that any supplemental indenture executed pursuant to the provisions of this *Article XII* complies with the requirements of this *Article XII*. Any such opinion shall comply with the requirements of *Section 9.07 (c)*.

SECTION 12.05. Debentures authenticated and delivered after the execution of any supplemental indenture pursuant to the provisions of this *Article XII* may bear a notation in form approved by the Trustee as to any matter provided for in such supplemental indenture. If the Company or the Trustee shall so determine, new Debentures so modified as to conform, in the opinion of the Trustee and the Board of Directors of the Company, to any modification hereof contained in any such supplemental indenture may be prepared by the Company, authenticated by the Trustee and deliv-

ered without cost to the holders of outstanding Debentures, upon surrender of such Debentures in equal aggregate principal amounts.

ARTICLE XIII.

Consolidation, Merger and Sale.

SECTION 13.01. The Company covenants and agrees that it will not sell, transfer or lease its property as an entirety or substantially as an entirety to, or consolidate or merge with any other corporation, or permit any other corporation to merge into it, unless such other corporation be a Wholly-Owned Subsidiary if as a result thereof, any of the property of the Company would become subject to any mortgage, pledge, lien, or encumbrance other than any to which such property was theretofore subject, unless the Company, prior thereto, shall, by indenture supplemental hereto, secure the outstanding Debentures, either alone, or equally and ratably with the whole or any part of any other indebtedness of the Company, by a direct lien on all such property of the Company prior to all liens other than any theretofore existing thereon.

SECTION 13.02. Subject to the provisions of *Section 13.01*, nothing contained herein shall prevent any consolidation or merger of the Company with any other corporation or corporations, or successive consolidations or mergers to which the Company or its successor or successors shall be a party or parties, or any sale, transfer or lease of the property of the Company or its successor or successors as an entirety or substantially as an entirety to any other corporation lawfully authorized to acquire the same; provided, that upon any such consolidation, merger, sale, transfer or lease, the due and punctual payment of the principal and interest of and on all the Debentures according to their tenor, and the due and punctual performance of all of the terms, covenants and conditions hereof to be kept or performed by the Company, shall, by an indenture supplemental hereto executed and delivered to the Trustee, be expressly assumed by the corporation, if other than the Company, formed by or surviving such consolidation or merger or acquiring or leasing such property; and every such successor, upon executing such indenture supplemental hereto in form satisfactory to the Trustee, shall succeed to and be substituted for the Company with the same effect

as if it had been named herein as party of the first part hereto, and shall possess and from time to time may exercise each and every power hereunder of the Company, and may execute and deliver Debentures hereunder, either in the name of the Company, or of such successor, and any act or proceeding required hereby to be done or performed by any board or officer of the Company may be done or performed with like force and effect by the like board or officer of such successor. Notwithstanding anything contained in this *Article XIII*, the Company shall not in any event be released from its liabilities or obligations under any of the provisions hereof or of the Debentures.

SECTION 13.03. The Trustee, subject to the provisions of *Section 9.01*, many receive an opinion of counsel, who may be counsel for the Company, as conclusive evidence that any such consolidation, merger, sale, transfer or lease and any such supplemental indenture comply with the provisions of this *Article XIII*. Any such opinion shall comply with the requirements of *Section 9.07 (c)*.

ARTICLE XIV.

Discharge of Indenture; Unclaimed Moneys.

SECTION 14.01. If (a) all the Debentures not theretofore cancelled shall have been delivered to the Trustee for cancellation, or (b) all of the Debentures having become due and payable, the Company shall well and truly pay or cause to be paid the whole amount of the principal, premium and interest due upon all the Debentures, or shall provide for such payment by depositing with the Trustee for the payment thereof the entire amount then due thereon for principal, premium and interest, or (c) prior to all of the Debentures having become due and payable, the Company shall deposit with the Trustee an amount sufficient to pay or redeem all the outstanding Debentures and in the case of redemption shall, unless notice of such redemption shall have been given, make arrangements satisfactory to the Trustee in respect thereof—and if in any such event the Company shall also pay or cause to be paid all other sums payable hereunder by the Company, and if the Company shall furnish to the Trustee a certificate signed by the President or any Vice-President and by the Secretary or any Assistant Secretary or the Treasurer or any Assistant Treasurer of the Com-

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pany stating that all conditions precedent to the satisfaction and discharge of this Indenture have been complied with, and an opinion of counsel, who may be counsel for the Company, stating that in its opinion such conditions precedent have been complied with (said certificate and opinion complying with the requirements of *Section 9.07 (c)*), then in such event this Indenture shall cease to be of further effect and shall terminate, and the Trustee on demand and at the cost and expense of the Company shall execute proper instruments acknowledging satisfaction of and discharging this Indenture.

SECTION 14.02. Any moneys deposited with the Trustee for the payment of principal, and/or interest on any Debentures and not applied to such payment within 4 years and ten months after the date of satisfaction and discharge hereof shall be repaid to the Company on demand; and thereupon the Trustee shall be released from all further liability with respect to such moneys, and the holder of such Debentures entitled to receive such payment shall thereafter look only to the Company, as the holder of a general claim, for the payment thereof; provided, however, that the Trustee, before being required to make any such repayment, may at the expense of the Company cause to be published at least once in a New York Daily Newspaper, a notice that such moneys have not been so applied and that after a date named therein any unclaimed balance of said moneys then remaining will be repaid to the Company.

ARTICLE XV.

Immunity of Incorporators, Stockholders, Officers and Directors.

SECTION 15.01. No recourse under or upon any obligation, covenant or agreement hereof, or of any Debenture, or because of the creation of any indebtedness evidenced hereby or thereby, shall be had against any incorporator, stockholder, officer or director, as such, past, present or future, of the Company or any successor corporation, either directly or through the Company or any successor corporation, whether by virtue of any constitution or statute or rule of law or equity, or by the enforcement of any assessment or penalty or otherwise, all such liability being expressly waived and released by the acceptance of any Debenture and as part of the consideration for the issue thereof.

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ARTICLE XVI.

Warrants to Purchase Common Stock.

SECTION 16.01. The Company will issue in conjunction with each $50 principal amount 5% Debenture Bond issued under this indenture a warrant evidencing the holder's right to subscribe to ½ share of common stock of the Company at a price of $10 per share, which warrant shall be in bearer form and shall be immediately detachable from said debenture and shall be valid until July 1, 1969 or until this indenture shall have been discharged in accordance with Article 14 hereof, whichever shall be the later date.

SECTION 16.02. The Trustee under this indenture, Fidelity-Philadelphia Trust Company, is hereby designated as warrant agent for the Company and all such warrants issued shall be valid only if, as, and when executed by the authorized officer of said trustee to validate said warrants. Said warrants shall be transferable by delivery and the warrant agent is hereby authorized to issue additional warrant certificates not in excess of 47,059 such warrants each evidencing the right to subscribe to ½ share of common stock upon surrender of any warrant to it.

SECTION 16.03. Said warrants shall be exercised by the holder thereof tendering to the warrant agent the warrant with the subscription provision executed on the reversed side thereof, together with a check in the amount of said subscription payable to the order of the Company. The warrant agent shall then notify the Company of such subscription and the Company shall thereupon issue and deliver a certificate or certificates for full shares of Common Stock in respect of which such warrant shall have been exercised and such shares shall be fully paid and non assessable. No fractional shares will be issued. The Company shall pay any and all original issue taxes required in connection with the issue of shares of common stock upon the exercise of any warrant.

SECTION 16.04. During the life of any said warrants, the Company shall not issue Common Stock for less than $10 per share payable in either cash or in property and the valuations of any such property received in exchange for such shares as fixed by the board of directors shall be conclusive.

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SECTION 16.05. Said warrants shall have no voting rights nor shall said warrants entitle the holder thereof to any notices from the corporation, nor shall said warrants be entitled to any pre-emptive right to the subscription of additional shares of common stock, nor to participate in any dividends or other distributions on common stock. In the case of issuance of additional shares of common stock as a dividend on existing common stock an amount equivalent to at least $10 per each share of the stock so issued shall be transferred to capital representing the issuance of additional shares irrespective of the then market or book value of such shares. The rights of said warrant holders shall be limited to those expressed in this Article XVI.

SECTION 16.06. Any sums received by the Company through the exercise of warrants issued hereunder shall be applied by the Company for sinking fund purposes in the fiscal year in which received in addition to the requirements as set forth in Article VI hereof.

ARTICLE XVII.

Miscellaneous Provisions.

SECTION 17.01. Nothing contained herein or in the Debentures express or implied, shall give or be construed to give to any person, firm or corporation, other than the parties hereto and the holders of the Debentures, any legal or equitable right, remedy or claim under or in respect hereof or under any covenant, condition or provision herein contained; and, subject to the provisions of *Section 15.01*, this Indenture and all its covenants, conditions and provisions shall be for the sole benefit of the parties hereto and of the holders of the Debentures.

SECTION 17.02. Any notice or demand which by any provision hereof is required or permitted to be given to the Company shall be sufficiently given for all purposes hereof if delivered or mailed either (a) to National Alfalfa Dehydrating and Milling Company, Lamar, Colorado, or at such other address as the Company may from time to time specify in writing to the Trustee, or (b) (except in the case of a notice given by the Trustee to the Company) to the Trustee at the principal office of the Trustee. Any notice, request or demand by the Company or any Debenture holder to or upon the Trustee shall be deemed to have been sufficiently given or made for all purposes if given or made at the principal office of the Trustee.

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SECTION 17.03. Wherever it is provided herein that the Trustee shall cancel any Debentures and deliver them to the Company, the Trustee may cancel and cremate such Debentures and deliver a certificate of cremation thereof to the Company.

SECTION 17.04. If and to the extent that any provision hereof limits, qualifies or conflicts with another provision hereof required to be included herein by any of Sections 310 to 317, inclusive, of the Trust Indenture Act of 1939, such required provision shall control.

SECTION 17.05. The date of this Indenture, to wit, July 1, 1957, is intended as and for a date for the identification of this Indenture and is not intended to indicate that this Indenture was executed and delivered on said date, this Indenture being executed and delivered as of the date of the acknowledgment thereof.

SECTION 17.06. All the covenants, stipulations, promises and agreements herein contained by or on behalf of or for the benefit of the Company or the Trustee shall bind and inure to the benefit of their respective successors and assigns, whether so expressed or not.

SECTION 17.07. The headings of the several Articles hereof and the statements contained in the Table of Contents prefixed hereto are inserted for convenience only and shall not control or affect the meaning or construction of any of the provisions hereof.

SECTION 17.08. This Indenture may be executed in any number of counterparts, each of which so executed shall be deemed to be an original, and such counterparts shall together constitute one and the same instrument.

SECTION 17.09. This Indenture and each Debenture issued hereunder shall be deemed to be a contract made under the laws of the Commonwealth of Pennsylvania and for all purposes shall be construed and enforced in accordance with the laws of said State.

SECTION 17.10. Fidelity-Philadelphia Trust Company, the party hereto of the second part, represents that it is fully authorized to enter into this Indenture and execute the trusts hereby created, and hereby accepts the trust herein declared and provided upon the terms and conditions herein set forth.

[π]

IN WITNESS WHEREOF, NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY, the party of the first part, has caused this Indenture to be executed in its corporate name by its President or one of its Vice-Presidents, and its corporate seal to be hereunto affixed and attested by its Secretary or one of its Assistant Secretaries, and Fidelity-Philadelphia Trust Company, the part of the second part, has caused this Indenture to be executed in its name by one of its Vice-Presidents and its corporate seal to be hereunto affixed and attested by one of its Assistant Secretaries, all as of the day and year first above written.

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY

By Henry O. Hoffman

President

Attest:

Secretary

(CORPORATE SEAL)

FIDELITY-PHILADELPHIA TRUST COMPANY

By

Vice-President

Attest:

Assistant Secretary

(CORPORATE SEAL)

[78]

COMMONWEALTH OF PENNSYLVANIA }
COUNTY OF PHILADELPHIA } SS.:

On this 24th day of July, before me personally came HENRY A. HOFMANN, to me known, who, being by me duly sworn, did depose and say that he resides at Sinking Spring, Pa.; that he is President of NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY, one of the corporations described in and which executed the foregoing instrument; that he knows the seal of said corporation; that the seal affixed to said instrument and purporting to be the seal of the said NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY is such seal; that is was so affixed by order of the Board of Directors of said corporation, and that he signed his name thereto by like order.

Jean C. Mascioli

(NOTARIAL SEAL)

Notary Public.

Notary Public, Philadelphia, Philadelphia Co.
My Commission Expires April 14, 1959

COMMONWEALTH OF PENNSYLVANIA }
COUNTY OF PHILADELPHIA } SS.:

On this 25th day of July 1957, before me personally came HARRY L. WALTERS, to me known, who, being by me duly sworn, did depose and say that he resides at Philadelphia; that he is Vice-President of Fidelity-Philadelphia Trust Company, one of the corporations described in and which executed the foregoing instrument; that he knows the seal of said corporation; that the seal affixed to said instrument and purporting to be the seal of the said Fidelity-Philadelphia Trust Company is such seal; that it was so affixed by order of the Board of Directors of said corporation, and that he signed his name thereto by like order.

G. Leonard Pappold

(NOTARIAL SEAL)

Notary Public.

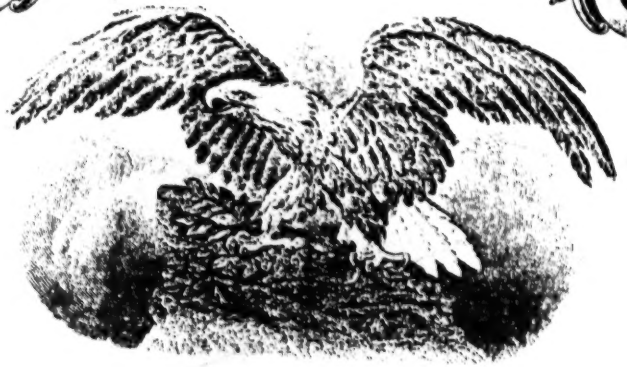
G. LEONARD PAPPOLD
Notary Public, Philadelphia County
135 S. Broad St., Philadelphia 9, Pa.
My Commission Expires July 16, 1959

STIPULATION EXHIBIT 13

Specimen Form of Debenture.

(154)

— NUMBER —

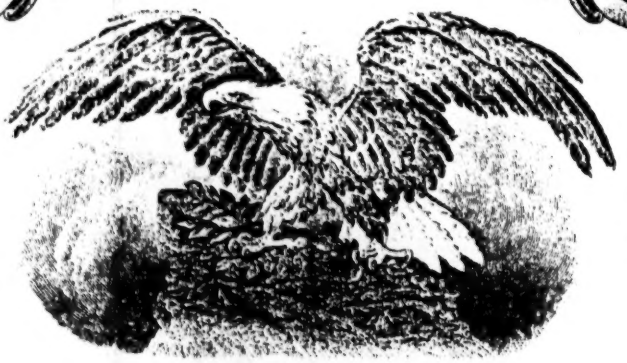


NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY

18 YEAR 5% DEBENTURE DUE JULY 1, 1975

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY (hereinafter called the "Company"), a corporation duly organized and existing under the laws of the State of Delaware, for value received, hereby promises to pay on the 1st day of JULY, 1975, to

—NUMBER—



NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY

18 YEAR 5% DEBENTURE DUE JULY 1, 1975

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY (hereinafter called the "Company"), a corporation duly organized and existing under the laws of the State of Delaware, for value received, hereby promises to pay on the 1st day of JULY, 1975, to

the registered holder hereof, at the principal office of the Trustee under the Indenture hereinafter mentioned, in the City of Philadelphia, Pennsylvania, the principal amount of

DOLLARS ($)

in lawful money of the United [illegible] payment is legal tender for [illegible] thereon at said office [illegible] year, at the rate of [illegible] paid or the payment [illegible]

This Debenture [illegible] the Company known as [illegible] the "Debentures") limited [illegible] $2,352,950, all issued and [illegible] Indenture dated as of July 1, 1957 [illegible] Company and Fidelity-Philadelphia Trust [illegible] Indenture and any indentures supplemental [illegible] lectively called the "Indenture") reference [illegible] tion of the rights, duties and immunities [illegible] the rights and limitations of rights [illegible] tures of the Company.

The Indenture [illegible] the Trustee, with the consent [illegible] aggregate principal amount of the then [illegible] as in the Indenture [illegible] any provisions of [illegible] provisions of the Indentures provided, however, that no such supplemental indenture shall (a) reduce the principal amount or extend the maturity of any of the Debentures without the consent of the holder of each Debenture so affected or (b) reduce the aforesaid percentage of Debentures, the consent of the holders of which is required to approve any such supplemental indenture, without the consent of the holders of all the outstanding Debentures.

In case a default as defined in the Indenture shall occur and be continuing, the principal of all outstanding Debentures may become or be declared due and payable before maturity, in the manner and with the effect provided in the Indenture.

The Indenture provides that the holders of a majority in principal amount of the then outstanding Debentures may on behalf of the holders of all of the Debentures waive any past default and its consequences, in the manner and to the extent provided in the Indenture. Any such waiver by the holder of this Debenture shall be conclusive and binding upon such holder and upon all future holders of this Debenture (unless

[illegible]), irrespective of whether [illegible] Debenture.

[illegible] d at any time by the [illegible] the Indenture at par [illegible], 1958.

[illegible] contingent sinking [illegible] provided in the [illegible] principal amounts aggre- [illegible] said sinking fund [illegible] as provided in the [illegible] price of 100% of the principal [illegible] with accrued interest to

[illegible] redemption and payment [illegible] to bear interest from

[illegible] principal in the holder's [illegible] city of Philadelphia, [illegible] Debenture. No service [illegible] transfer, but the Com- [illegible] any stamp tax or [illegible] thereof.

[illegible] in whose name [illegible] of this Debenture, [illegible] the purpose of receiv- [illegible] neither the Company [illegible] be affected by any notice to the contrary.

[illegible] obligation, covenant or agreement [illegible] Debenture, or because of the creation of any [illegible] shall be had against any incorporator, [illegible] as such, past, present or future, of the [illegible] corporation, either directly or through the [illegible] corporation, whether by virtue of any constitu- [illegible] or rule of law or equity or by the enforcement of any [illegible] or otherwise, all such liability being by the accept- [illegible] hereof and as part of the consideration for the issue hereof expressly waived and released, as provided in the Indenture.

This Debenture shall not become valid or obligatory for any purpose until the certificate of authentication hereon shall have been executed by the Trustee.

IN WITNESS WHEREOF, NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY has caused this Debenture to be signed by its President or one of its Vice-Presidents by imprinting thereon the facsimile signature of such officer and a facsimile of its corporate seal to be imprinted hereon and attested by the facsimile signature of its Secretary or an Assistant Secretary.

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY

Dated:

BY Henry A. Hoffmann

PRESIDENT

ATTEST: L. R. Olsen

SECRETARY

THIS IS ONE OF THE DEBENTURES DESCRIBED IN THE WITHIN MENTIONED INDENTURE.
FIDELITY-PHILADELPHIA TRUST COMPANY,
TRUSTEE.

BY

AUTHORIZED OFFICER.

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY CORPORATE SEAL 1946 DELAWARE

CE 7842

FOR VALUE RECEIVED

the undersigned sells, assigns and transfers unto

_____

_____

the within Debenture of

NATIONAL ALFALFA DEHYDRATING
AND MILLING COMPANY

and does hereby irrevocably constitute and appoint

_____ *Attorney*

to transfer the said Debenture on the books of the within-named Company, with full power of substitution in the premises.

Dated: _____

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY

18 YEAR 5% DEBENTURE DUE JULY 1, 1975

PRINCIPAL PAYABLE

JULY 1, 1975

INTEREST PAYABLE

JANUARY 1 AND JULY 1

PRINCIPAL AND INTEREST PAYABLE AT THE PRINCIPAL OFFICE OF THE TRUSTEE, IN THE CITY OF PHILADELPHIA, PENNSYLVANIA

Stipulation Exhibit 14

Specimen Form of Warrant.

(155)

VOID AFTER JULY 1, 1969

No. W

TWELVE YEAR WARRANT FOR THE PURCHASE OF COMMON STOCK

_____ Shares

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY

THIS CERTIFIES that the bearer is entitled to purchase at $10 per share on or before the close of business on July 1, 1969 unless extended as provided in the Indenture between the Company and Fidelity-Philadelphia Trust Company dated as of July 1, 1957 (hereinafter called the "Indenture") the number of shares indicated on the face hereof of fully paid, non-assessable shares of common stock of the par value of three dollars ($3.00) per share of National Alfalfa Dehydrating and Milling Company, a Delaware corporation (hereinafter called the "Company"), upon surrender of this Warrant to the Warrant Agent, with the subscription form on the back hereof duly executed and the payment to said Warrant Agent for the account of the Company of the full purchase price in cash for the shares hereby represented, subject to all of the terms and conditions hereof and the provisions relating to Warrants contained in a certain Trust Indenture dated as of July 1, 1957 between the Company and Fidelity-Philadelphia Trust Company, as Trustee, in which the rights of the bearer of this Warrant, and the terms and conditions upon which this Warrant is issued and may be exercised, and the restrictions on its exercise which may arise under Federal or State securities laws are more fully set forth, to all of which every bearer of this Warrant, by acceptance hereof, assents.

This Warrant is issued in conjunction with a 5% Debenture Due July 1, 1975, both issued under the Indenture, a copy of which is on file at the registered office of the Company, and at the office of the Warrant Agent of the Company. This Warrant may be presented and surrendered by its bearer to the Warrant Agent in accordance with its rules and exchanged for any number of other Warrants evidencing the right to purchase whole shares of the common stock of the Company in a total amount which does not exceed the number of shares appearing on the face hereof.

The Indenture contains certain prohibitions against issuance of Common Stock for less than the price contained in this Warrant and certain other restrictions. No fractional shares of common stock will be issued upon the exercise of this Warrant as provided in the Indenture.

The holder of this Warrant, as such, shall not be entitled to any of the rights of a stockholder and shall not be entitled to receive any notice whatsoever from the Company, the Trustee or the Warrant Agent.

This Warrant and all rights represented hereby shall pass by delivery in the same manner as a negotiable instrument payable to bearer.

This Warrant shall not be valid unless it contains the signatures or facsimile signatures of the Warrant Agent and of the Company's President or Vice President and attested by its Secretary or Assistant Secretary.

WITNESS the facsimile signatures of the proper officers of the Company and its facsimile seal.

DATED:

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY

COUNTERSIGNED:
FIDELITY-PHILADELPHIA TRUST COMPANY
WARRANT AGENT

BY

SPECIMEN

AUTHORIZED OFFICER

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY CORPORATE SEAL 1946 DELAWARE

BY Henry P. Hofmann

PRESIDENT

ATTEST: Ellen

SECRETARY

DEVINNEY BLANKBOOK COMPANY

SURRENDER FOR OTHER WARRANTS

The undersigned, holder of the within Warrant, hereby surrenders and exchanges said Warrant for_____Warrants each for the purchase of_____shares.

Date_____

Signature_____

_____
STREET ADDRESS

_____
CITY STATE

SUBSCRIPTION

The undersigned, holder of the within Warrant, subscribes for the number of shares of common stock of National Alfalfa Dehydrating and Milling Company which the undersigned is entitled to purchase under the terms of the within Warrant according to the terms and conditions thereof, and herewith makes full payment of the purchase price for said shares.

Date_____

Signature_____

_____
STREET ADDRESS

_____
CITY STATE

STIPULATION EXHIBIT 15

Journal Entries Re Debentures.

(157)

THE NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY

JOURNAL ENTRY

Setting up Debentures

NO. 143

DATE Aug. 6, 1957

T. NO.	ACCOUNT	DEBITS	CREDITS
69	Eighteen Year 5% Debentures		2357 95 00
71	Preferred Stock	2357 95 00	

To provide for the retirement of the 5% Cumulative Preferred Stock of the Company under the provisions of the reorganization and recapitalization plan approved at the Annual Meeting of the Stockholders of the Company held July 23, 1957.

To provide for the retirement of the 5% Cumulative Preferred Stock of the Company under the provisions of the reorganization and recapitalization plan approved at the Annual Meeting of the Stockholders of the Company held July 23, 1957.

NOTATION RE STIPULATION EXHIBIT 16

Stipulation Exhibit 16, a Ruling Letter dated May 29, 1957, from Chief, Reorganization and Dividend Branch, U.S. Treasury Department, Washington, D.C. is set forth as Exhibit B to the Petition in the Tax Court, and appears supra, *pp. 17–21. It is therefore not reprinted here.*

STIPULATION EXHIBIT 17

Letter, Dated August 14, 1959, From Francis I. DuPont & Co.

(160)

FRANCIS I. DUPONT & CO.
ROBINSON BUILDING
N. W. COR. 15th & CHESTNUT STREETS
PHILADELPHIA 2, PA.
LOCUST 3-0710

MAIN OFFICE
ONE WALL STREET
NEW YORK

MEMBERS
NEW YORK STOCK EXCHANGE
AND OTHER LEADING EXCHANGES

DU PONT BUILDING
WILMINGTON

August 14, 1959

Price Waterhouse & Co.
Attn: Mr. Robert M. Griffiths
123 South Broad Street
Philadelphia 9, Pa.

Gentlemen:

According to our records National Alfalfa Dehydrating & Milling Company Preferred stock was quoted in the Over-The-Counter market during July 1957 as listed below:

Date	Bid	Offer	
July 15	33	35	34
July 16	32	35	33.5
July 17	32	34	33
July 18	31	34	32.5
July 19	32	34	33
July 22	31	33	32
July 23	32	34	33
July 24	32	35	23'/.0
July 25	29	32	
July 26	30	33	7)35
July 29	30	33	
July 30	30	33	

I trust this is the information you wanted, if not kindly let me know.

Very truly yours,

Robert W. Drummond

RWD:p

STIPULATION EXHIBIT 18

National Monthly Stock Summary, Issue of October 1, 1957.

The National Monthly Stock Summary

ISSUE OF

October 1, 1957

Contains a summarization of Stock Market Quotations which have appeared in the NATIONAL DAILY SERVICES, or have been supplied by dealers on special lists between April 1, 1957 and October 1, 1957.

Copyright 1957 by
THE NATIONAL QUOTATION BUREAU
Incorporated
46 Front Street, New York 4, N. Y.
Tel. Whitehall 3-4200

Printed in U. S. A.

THE NATIONAL SERVICES

MONTHLY BOND SUMMARY:

A cumulative list for six months of bond market quotations which have appeared in the National Daily Quotation Services or have been supplied by dealers on special lists. Also gives original houses of issue, dealers' names, date and price of offerings and other statistical information of great value.

MONTHLY STOCK SUMMARY:

Entirely uniform with the Monthly Bond Summary but covering Stocks. Listing thousands of over-the-counter and Inactive Listed Stocks.

NATIONAL DAILY QUOTATION SERVICE:

A service sent out each night from our New York, Chicago and San Francisco offices and containing offerings and wants from the principal investment and trading houses throughout the country. Listing privilege is subject to certain restrictions which will be furnished on application.

NATIONAL QUOTATION BUREAU
Incorporated
46 Front Street, New York 4, N. Y.
Tel. WHitehall 3-4200

BOSTON OFFICE
79 Milk Street, Boston 9, Mass.
Tel. HUbbard 2-4550

CHICAGO OFFICE
173 West Madison Street, Chicago 2, Ill.
Tel. STate 2-7971

PHILADELPHIA OFFICE
Commercial Trust Bldg., Philadelphia 2, Pa.
Tel. Rittenhouse 6-8938

SAN FRANCISCO OFFICE
465 California Street, San Francisco 4, Cal.

CONTENTS OF THIS SERVICE

A summarization of stock market quotations which have appeared in the

NATIONAL DAILY SERVICES

or have been supplied by dealers on special lists.

PLEASE NOTE CAREFULLY

Where we can obtain the information we will incorporate in this Summary the following data:

PAR VALUE (Par)—Given in parenthesis after title or to indicate changes.

LISTED—The name of the city or cities, following this word indicates that the security is registered and fully listed on the Stock Exchange in said city or cities—**Listed, N.Y.** (New York Stock Exchange).

OUTSTANDING (Out.)—This is a record of the latest information we have been able to obtain as to the amount of stock outstanding. Should a large portion of this stock be controlled by any particular interest, it will be shown as follows:

NORTHERN CENTRAL RY CO.
—COM (50) Listed N Y., Phila-Balt. Transfers Fidelity-Baltimore National Bank, Balt.—Pennsylvania R R Co, N Y. Out. 623,625 shs. Div. 94-52 J & J 15.
Control—Pennsylvania R R Co. and its affiliates own approx. 76% as of Dec. 1953.

DIVIDENDS (Div.)—This information shows the annual rate with payment dates if our records show that a dividend is being paid regularly. When the rate is followed by a definite date, this shows the last record of dividend payment. When dividend is paid out of income which is guaranteed, the information will appear as follows:

NORTHERN CENTRAL RY CO.
—COM (50) Listed N Y., Phila-Balt. Transfers Fidelity-Baltimore National Bank, Balt.—Pennsylvania R R Co, N Y. Out. 623,625 shs. Div. 94-52 J & J 15.
Note—Pennsylvania R R Co guarantees rental of 8% yearly on outstanding stock.

CONVERTIBLE (Conv.)—A summary of the conversion privilege.

REDEEMABLE—A summary of the redeemable privilege.

SINKING FUND—(S.F.)—A summary of the sinking

COMPANY'S OFFICE (Office)—Principal office.

TRANSFER OFFICE (Transfers)—When transfer office is given on only one class of stock which a company may have outstanding, it may be assumed that this applies to all classes.

RANGES—The ranges for issues regularly quoted in "The National Daily Quotation Service" represent the high bids shown therein. For the less active issues the ranges represent the high bids in either the daily or monthly services. For investment trust issues the ranges in most cases are compiled from quotations supplied by the sponsors. Bids are to the first day of the month preceding publication. An asterisk (*) indicates that bids have been adjusted to show stock splits and stock dividends. Since only bid prices are used in compiling these ranges it is quite probable that transactions have taken place at higher prices. In no case have offering prices been given consideration.

PUBLIC OFFERING (Offered)—This information shows the terms on which the issue has been offered to the public and to stockholders. Securities issued in this country since 1933 are designated as "New," "Additional" or "Block issues".

NOTES—Will include all general information which we think will be of value to the subscriber, i.e., receivership, merger, control, acquired, etc.

LETTERS FOLLOWING TABULATION OF STOCK OFFERED OR WANTED, REPRESENT:

D—National Daily Quotation Service

L—Special Typewritten List

The alphabetical arrangement differs from some other books of reference in that compound titles with "&" precede names without "&", i.e., New York & Richmond precedes New York Central R.R.

Bids and offerings in this Summary are arranged with the most recent at the bottom.

The information in this service has been compiled with extreme care. It has been obtained from sources which we believe are reliable and accurate but we cannot guarantee it.

Na

NATICK TRUST CO Natick, Mass.
—CAP ($25) Oct. 6,000 shs. Div. 60% in stk in 1-52.
Capital Change—Jan. 1952 par changed from $100 to $25. Basis: 4 new shs for 1 old. Outstanding then increased to 6000 shs by 50% stock div.

Paul D Sherbine & Co Bos	5-29-57	@ 91		L
Townsend Dabney & Tyson Bos	5-29-57	@ 90		L
Dayton Haigney & Co Inc Bos	5-29-57	@ 90		L
S Weinberg & Co N Y	5-29-57	@ 90		L

NATION-WIDE SECURITIES CO INC (Md.) 1 Wall St., New York City.
—(1) Transfers Irving Trust Co, N Y., Trust Co of New Jersey N J. Out. 1,410,840 shs. Div. $1 9-27-57.
Changed—June 1942 to Corporate Shares, A 1. (3)
Note—Converted by Bullock Fund Ltd

RANGE 1945-55 20.03-12.23 1956 20.43-18.18 1957 19.23-18.07

Asiel & Co N Y	11-30-56	@ 19.61	@ 19.80	D
Smith Barney & Co Chgo	1-31-56	to date		D

NATIONAL ACCIDENT & HEALTH INSURANCE CO OF PHILADELPHIA (Pa.) 242 So. 8th St., Philadelphia, Pa.
—($10) Transfers Co office. Out. 50,000 shs Div. 10% stk 3-1-58.
Capital Change—Mar 1956 shs increased to 50,000 by 10% stk div.

H A Riecke & Co Phila	4- 5-57	@ 20		L
Hemphill Noyes & Co Phila	4-29-57	@ 20		L
Lilley & Co Phila	5-31-57	@ 22		L
Franklin & Co N Y	6-28-57	@ 20		L
S Weinberg & Co N Y	6-28-57	@ 20¼		L

NATIONAL ACME CO (Ohio) COM ($1) Listed N Y—Midwest. Out. $500,000. Div. $2-50¢ qt 8-23 extra 50¢ 8-23-57 Office 170 E 131st St., Cleve. Transfers Bankers Trust Co, N Y—Cleveland (O) Trust Co.

NATIONAL AERONAUTICAL CORP (N. J.) 189 S. Main St., Ambler, Pa.
—COM (No Par) Transfers Co office. Out. 49,257 shs. Div. 25¢ 4-30-57 25¢ 7-30-57.
New Issue—April 1952 18,445 shs. at $5 by company.

Auchincloss Parker & Redpath N Y	6- 6-57	100@ 21		D
Carl M Loeb Rhoades & Co N Y	6-17-57	@ 35		D
Tyche Securities Inc N Y	8-14-57	@ 25		D
Woodcock Hess Moyer & Calne Phila	8-23-57	@ 40		D
Laird & Co Corp Wilm	8-26-57	@ 45		D
Thayer Baker & Co Phila	8-30-57	2042 45		D
Yarnall Biddle & Co Phila	9-23-57	@ 46		D
Arthur L Wright & Co Inc Phila	9-30-57	@ 40		D

NATIONAL AGROL CO (Mich) 921 17th St., N. W. Washington D. C.
—COM ($1) Transfers Co. office. Out. 421,000 shs. (F)
Howell O Archard & Co N Y 10-29-53 1300 @ .05 D

NATIONAL AIRLINES INC (Fla) 3540 N. W. 27th Ave., Miami
—COM ($1) Listed N Y. Transfers Chase Manhattan Bank N Y. Out. 1,000,000 shs. Div. $1-25¢ qt 1-25.
Addt'l Issue—to offered holders shs (in all states in which co is qualified to offer stock) at $2.50 in July 1938.
Addt'l Issue—March 1941 50,000 shs $7.50 by Lehman Bros
Addt'l Issue—June 1944 173,333 1-3 shs at $13⅓ by Lehman Bros N Y. Reg Act of 1933 effective 6-6-44.
Block Issue—Aug 1945 20,700 shs at $23½ by Lehman Bros N Y
Addt'l Issue—Aug 1946 150,000 shs at $25¼ by Lehman Bros N Y et al Reg Act of 1933 effective 8-13-45.
Addt'l Issue—March 1949 174,000 shs sold privately at $5¼ per sh
Addt'l Issue—March 1949 10,000 shs sold privately at $5½ per sh
Addt'l Issue—April 1949 66,013 shs sold privately at $6½ per sh
Block Issue—Oct 1951 120,000 shs placed privately through Blair Rollins & Co.

NATIONAL ALFALFA DEHYDRATING & MILLING CO (Del) Lovell, Colo
—PFD 5% CUM ($50) Div. 62½¢ 3-1-53.
Exchange—July 1957 $50 of S F Deb 5s July 1975 plus 1 warrant for 1 Pfd.

Bache & Co N Y	4-15-57	200@ 26		D
Leone & Pollack N Y	4-17-57		100@ 33	D
Joseph Walker & Sons N Y	4-25-57		@ 35	D
Norton Adams & Co N Y	7- 9-57	100@ 32		D
Mitchell & Co N Y	7-10-57	@ 33		D
Hornblower & Weeks N Y	8- 5-57		@ 35	D
Lilley & Co Phila	9- 3-57	100@ 25¼	100@ 33	D
B C Christopher & Co K C	9-13-57	500@ 25½		D
W E Hutton & Co N Y	9-16-57			D
Wertheim & Co N Y	9-27-57	25	500@ 31	D
B W Pizzini & Co Inc N Y	9-27-57			
Gordon Graves & Co Inc N Y	9-30-57	@ 28	@ 31	

—COM ($3) Transfers First National City Bank N Y. Out. 775,000 shs. Div. 12¢ 9-1-57.
Block Issue—Nov 1946 586,220 shs at $3 by Stone & Webster Securities Corp, N Y, Bosworth Sullivan & Co Denver, First Boston Corp, Blyth & Co Inc, Clark Dodge & Co, Goldman Sachs

Na

		Bid	Offering	

& Co, Smith Barney & Co, White Weld & Co all of N Y, Graham Parsons & Co, Phila, Boettcher & Co Denver, et al.

Addt'l Issue—Apr 1954 62,200 shs sold privately through Paine Webber Jackson & Curtis.

Par Changed—July 1957 $1 to $3 sh for sh.

Lilley & Co Phila	6-11-57	100@ 3⅜		D

—WARRANTS—at $10 expire 7-1-65.

Birnbaum & Co N Y	8- 2-57	500@ .75		D
Sprayregen & Co N Y	8- 6-57	500@ .65		D
Swaim & Co Inc Phila	8-26-57	@ .70		D
Butcher & Sherrerd Phila	8-30-57	@ .75		D
Lilley & Co Phila	9-13-57	500@ .95		D
Mitchell & Co N Y	9-24-57	@ 1		D
Wertheim & Co N Y	9-27-57	1M@ .75		D
Investment Secs Corp Chatt	9-27-57	@ .70		D
Gerstley Sunstein & Co Phila	9-30-57	@ .90		D

NATIONAL ALUMINATE CORP (Del.) 6216 W. 66th St., Chicago

—COM ($2.50) Transfers Northern Trust Co Chgo. Out. 1,120,712 shs. Div. $1.20-30¢ qt 12-10.

Block Issue—Feb 1947 127,000 shs at $24 by Lee Higginson Corp N Y, First Boston Corp, N Y et al. Reg. Act of 1933 effective 2-26-47.

Block Issue—Dec 1952 10,000 shs sold by Blunt Ellis & Simmons.

Capital Change—April 1955 shs increased to 1,100,000 by 100% stk div.

RANGE 1947-55 $27-63⅜ 1956 57⅜-30½ 1957 41-30

Dean Witter & Co Chgo	4- 3-57			50@ 30½	D
Cruttenden Podesta & Co N Y	4-16-57	@ 33⅛			D
Cruttenden Podesta & Co Chgo	4-17-57	100@ 33			D
Woodard-Elwood & Co Minpls	4-23-57	100@ 33			D
Aetna Secs Corp N Y	5-15-57			100@ 35¼	D
Morris Cohon & Co N Y	5-16-57	@ 34⅜		@ 35½	D
Shearson Hammill & Co Chgo	5-24-57	@ 35¼			D
Shearson Hammill & Co N Y	5-24-57	@ 35¼			D
Blache & Co Chgo	7- 1-57			100@ 33½	D
S H Gibb & Co N Y	8-12-57			@ 42	D
J J FitzGerald Co N Y	9- 3-57			100@ 35½	D
Paine Webber J & C Chgo	9-18-57	100@ 35			D
Goodbody & Co Chgo	9-23-57			50@ 34	D
McMaster Hutchinson & Co Chgo	9-24-57	@ 34		@ 36	D
Sincere & Co Chgo	9-25-57	@ 34		@ 35½	D
Gardner F Dalton & Co Milw	9-30-57	@ 33		@ 35	L
Lee Higginson Corp Chgo	9-30-57	@ 33½		@ 34½	D
Lee Higginson Corp N Y	9-30-57	@ 33		@ 35	D
Swift Henke & Co Chgo	9-30-57	@ 33		@ 35	D
EastmanDillonUnSecs&Co N Y	9-30-57	@ 33		@ 35	D
EastmanDillonUnSecs&Co Chgo	9-30-57	@ 33		@ 35	D
Blunt Ellis & Simmons Chgo	9-30-57	100@ 33⅛	100@ 35		D
Doyle O'Connor & Co Inc Chgo	9-30-57	@ 33		@ 35	D

NATIONAL AMERICAN BANK OF NEW ORLEANS 200 Carondelet St., New Orleans, La.

—CAP ($100) Out. $2,000,000. Div. $2-62 qt 1-1 extra $8 1-2-57

Capital Change—March 1948 out. increased to $2,800,000 by sale of 5000 addt'l shs.

Franklin & Co N Y	8- 7-57	@375		D
Robert Garrett & Sons N Y	8-27-57		@406	D
Francis I du Pont & Co N Y	9-30-57	@375		L

NATIONAL AMERICAN INSURANCE CO. Omaha, Neb.

—($50) Transfers Co. office. Out. $1,000,000.

Eastern Secs Inc N Y	5-23-57		3@130	D
Harry O Valleau & Co Chgo	6- 6-57	@150		D
Tweedy Browne & Reilly N Y	8-23-57	@150		D
Gartman Rose & Co N Y	8-28-57	@150		D
John Douglas & Co Inc Omaha	8-30-57		33@150	D

NATIONAL APEX INDUSTRIES CORP (Ohio) 706 Citizens Bldg., Cleveland, Ohio

Formerly—National Bronze & Aluminum Foundry Co to May 1955

—COM (50 Cents) Transfers Cleveland (O.) Trust Co. Out. 198,166 shs.

Par Changed—May 1955 $1 to 50 cents sh for sh.

Capital Change—Aug 1955 shs increased by offer of 298,749 at 50 cents to holders of record 8-1-55. Basis: 1½ for 1.

Franklin & Co N Y	4-25-57	@ ⅜		L
Wm J Mericka & Co Inc Cleve	9-30-57	1M@ ⅜		L

NATIONAL AUTOMATIC TOOL CO INC (Ind.) Richmond, Ind.

—COM ($100) Transfers Co. office Out. 10,000 shs (1)

Howell O Archard & Co N Y	8-21-57	100@ 9		D

NATIONAL AUTOMOTIVE FIBRES INC (DEL) 19925 Hoover Ave., Detroit

—COM ($1) Listed N Y—S F. Transfers Guaranty Trust Co N Y. Out. 1,095,787 shs. Div. 25¢ 9-1-56.

Block Issue—Nov 1949 15,975 shs at 31⅜ by Reynolds & Co N Y.

Addt'l & Block Issue—April 1956 173,800 shs at 31⅜ by Reynolds & Co N Y, Schwabacher & Co, S F, Laurence M Marks & Co N Y, Hemphill Noyes & Co N Y, A C Allyn & Co Inc Chgo, et al. Reg. Act of 1933 effective 4-16-46.

Capital Change—Dec. 1955 shs increased to 1,095,787 by 10% stk div.

NATIONAL AVIATION CORP (N Y) 111 Broadway, New York.

STIPULATION EXHIBIT 19

Summary of Sinking Fund Activity.

(169)

NATIONAL ALFALFA DEHYDRATING & MILLING COMPANY

Summary of Sinking Fund Activity as Recorded
in Ledgers of The Fidelity Bank, Trustee
18 Year 5% Debentures Due 7/1/75

Date	Cash Deposited by Company in Sinking Fund	Bonds Deposited by Company in Sinking Fund	Bonds Purchased In Open Market or Call by Trustee	Cash From Exerc of War
1957				
1958				
1959		113 000		
1960		279 250		
1961		468 500		
1962		23 050		
1963	70 600	26 000	5 000	
1964	176 830	22 750	82 850	
1965			158 950	
1966	367 740	22 600		
1967		203 000	365 450	
1968	176 150	13 000	200 450	21 3
1969			10 100	10 0
1970				
TOTALS	791 320	1 171 150	822 800	31 3

Prepared by:

J Eric Crooks
Assistant Secretar
1/26/71

STIPULATION EXHIBIT 20

Notice of Annual Meeting of Stockholders.

(171)

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY

LAMAR, COLORADO

Notice of Annual Meeting of Stockholders

TO THE HOLDERS OF COMMON STOCK AND 5% CUMULATIVE PREFERRED STOCK OF NATIONAL ALFALFA DEHYDRATIN AND MILLING COMPANY:

Notice is hereby given that the Annual Meeting of Stockholders of National Alfalfa Dehydrating and Milling Co pany, a Delaware Corporation, will be held at the office of the Company, in Lamar, Colorado, on Tuesday, July 23, 195 at 1 o'clock p.m., Mountain Standard Time, for the following purposes:

For Action by the Holders of the 5% Cumulative Preferred Stock

1. To elect four members of the Board of Directors voting as a class.

2. To transact such other business as may properly come before a meeting of the 5% Cumulative Preferred sha holders.

For Action by the Holders of the Common Stock and 5% Cumulative Preferred Stock, Each Votin as a Class

3. Voting on a resolution to

(a) Approve or disapprove a plan of reorganization whereby a $50, 5% debenture due July 1, 1975, will be issued Preferred shareholders for each share of 5%, $50 par value, Cumulative Preferred share surrendered.

(b) Approve an increase of indebtedness of the Corporation by an amount of $2,352,950 and authorize the executi of an indenture under which the Company would issue debentures in said amount to holders of Preferred Stock for surr der of said Preferred Stock. The exchange of debentures for Preferred Stock shall be on a basis of one $50, 5% debent due July 1, 1975, for each 5%, $50 par value Cumulative Preferred share surrendered.

(c) Authorize the issue of certain stock warrants in lieu of dividend arrearages on the Preferred Stock to all Pr ferred shareholders participating in exchange of their Preferred Stock for debentures of the Company, on the basis of o warrant for each $10 accumulation of dividend arrearages, which warrants shall entitle the bearer thereof to subscribe ½ share of the Common Stock of the Company at a price of $10 per share.

(d) Amend the certificate of incorporation to reflect the retirement of the Preferred Stock of the Company and chan in par value of the Common Stock from $1 per share to $3 per share, and transfer from Paid-in Surplus to Capital $1,5 000 which is an amount sufficient to reflect the change in par value of the Common Stock of the Company from $1 to per share.

4. To ratify an amendment of by-laws, adopted by the Board of Directors on February 8, 1957, increasing the nu ber of the Board of Directors from 12 to 13 members.

For Action by the Holders of Common Stock

5. To elect nine members of the Board of Directors voting as a class.

6. To transact such other business as may properly come before a meeting of shareholders.

Lamar, Colorado
June 21, 1957

By Order of the Board of Directors,
L. R. POLLOCK, *Secretary*.

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY
PROXY STATEMENT FOR ANNUAL MEETING OF STOCKHOLDERS
To Be Held July 23, 1957

This statement is furnished to stockholders in connection with the solicitation by and on behalf of the Management of National Alfalfa Dehydrating and Milling Company (the "Company") of proxies to be used at the Annual Meeting of Stockholders of the Company to be held at its office in Lamar, Colorado, on July 23, 1957, and at any adjournment or adjournments thereof, for the purposes set forth in the attached Notice of Meeting. If the enclosed form of Proxy is executed and returned, it will be voted for the nominees set forth herein. Any stockholder who executes a proxy may revoke it at any time before it is voted. However, the presence of a stockholder at the meeting does not revoke his proxy. Proxies for Common Stockholders or Preferred Stockholders, as applicable, are enclosed with this Proxy Statement. If a stockholder holds both Common and Preferred Stock, he should execute both forms of Proxy.

It is the intention of the proxy holders to vote in favor of proposals 3 and 4 as set forth in said notice.

The Company will bear the cost of solicitation of proxies. In addition to the use of the mail, proxies may be solicited personally or by telephone or telegraph, by the directors or by a few regular executives or employees of the Company at a nominal cost, and the Company may reimburse brokers and other persons holding stock in their names or in the names of their nominees, for their expenses for sending proxy soliciting material to principals.

The Company has outstanding 790,000 shares of Common Stock and 47,059 shares of 5% Cumulative Preferred Stock ("Preferred Stock") entitled to vote at the meeting. Each share of both classes of stock has one vote and each class will vote as a class on the matters concerning it, as set forth in the accompanying notice of meeting. Only stockholders of record at the close of business on June 21, 1956, may vote at the meeting.

On May 1, 1957, the persons owning of record or, to the best knowledge of the management, beneficially, more than 10% of the outstanding securities of any class of securities of the Company entitled to vote at the meeting, were as follows:

Name and Address	*Title of Class*	*Type of Ownership*	*Shares Owned*	*Per Cent of Class*
Grain Elevator Warehouse Company 927 Market Street Wilmington, Delaware	5% Cumulative Preferred Stock	Record and Beneficial	9,802	20.8
	Common Stock	Record and Beneficial	142,132	18.2
Wright J. Small 12th and Oak Streets Kansas City, Mo.	5% Cumulative Preferred Stock	Record and Beneficial	13,268	27.8
Francis I duPont & Company[a] 149 Broadway New York, N. Y.	Common Stock	Record	250,642	31.8

[a] Approximate.

[b] Francis I. duPont & Company, Investment Bankers, with whom Mr. Drummond is associated, have registered in their name the shares listed above, which they hold for the accounts of their various customers.

SECTION 1. RESPECTING THE ELECTION OF DIRECTORS

(a) To Be Elected by Common Stockholders

At the meeting, the Management proposes that the nine persons named below, whose terms expire with this meeting, be elected as directors representing the Common Stockholders, each of whom will hold office for one year or until their successors are elected and qualified. All of these persons were elected as directors of the Company at the previous Annual Meeting of Stockholders held July 24, 1956, except Clarence M. Saunders, who was elected by the Board of Directors on February 8, 1956.

For more than the past five years Mr. Saunders was president of Saunders Mills, Inc., Toledo, Ohio, whose properties were acquired by the Company. He has been a recognized leader in the industry for over 25 years. He is presently the owner of Farm Industries, Inc., Perrysburg, Ohio, which engages in farming and livestock breeding.

It is the intention of the persons named in the accompanying form of Common Stockholders' Proxy to vote such proxy for the election of the nine nominees listed below. The management does not contemplate that any of such nominees will be unable to serve as director for any reason, but if that should occur prior to the meeting, the proxy holders reserve the right to substitute another person of their choice as nominee in his place and stead.

INFORMATION ABOUT NOMINEES AND DIRECTORS TO BE ELECTED BY COMMON STOCKHOLDERS

Name of Nominee	Principal Occupation (and employment history where required to be stated)	Served Continuously as Director Since	Shares of Preferred Stock Owned Beneficially as of June 1, 1957	Shares of Common Stock Owned Beneficially as of June 1, 1957
John F. Connelly	President and Chairman of the Board, Crown Cork and Seal Company, Inc., Baltimore, Maryland (cans and closures), and Chairman of the Board, Connelly Containers, Inc., Philadelphia, Pa. (corrugated boxes).	5/15/53	None	13,450[1]
James J. Davis	Attorney at Law, Davis, Marshall & Crumlish, Philadelphia, Pa.	3/12/52	None	5,000[1]
Robert W. Drummond	Investment Banker and Broker, Francis I. duPont & Company, Philadelphia, Pa.	6/15/51	None	11,600[1]
Edgar M. Tutwiler	President, Appalachian Tire Products Company, Mt. Hope, West Virginia.	3/12/52	None	1,800
Henry A. Hofmann	President, National Alfalfa Dehydrating and Milling Co., Lamar, Colorado; President, Hofmann Industries, Inc., Sinking Spring, Pa. (tubular steel products and brooms).	7/28/53	256	14,834[1]
John R. Porter	President, Porter Oil and Gas Co., Oklahoma City, Oklahoma.	6/7/50	None	10,100[1]
Clarence M. Saunders	President, Farm Industries, Inc., Toledo, Ohio.	2/8/56	None	17,518
Louis Silverstein	President, Camden Fibre Mills, Philadelphia, Pa. (cotton linters and batting); Director, Camden Trust Co., Camden, N. J.	11/17/54	None	2,500[1]
F. N. Piasecki	President, Piasecki Aircraft Corp., Philadelphia, Pa.	7/26/55	None	100[1]

[1] The substantial reduction in holdings of these directors was occasioned by their exchange of shares for units of Grain Elevator Warehouse Company in July, 1956.

(b) To Be Elected by Preferred Stockholders

In accordance with the Charter and By-Laws of the Company, the Preferred Stockholders, voting as a class, are entitled to elect one-third of the Board of Directors while an arrearage exists thereon, which as of June 1, 1957, amounted to $10 per share.

At the meeting, the Management proposes that the four persons named below, all of whose terms expire with this meeting, be elected as directors representing the Preferred Stock, each of whom will hold office for one year or until their successors are elected and qualified. All of them are now serving on the Board of Directors, having been elected thereto at the previous Annual Meeting of Stockholders, adjourned to September 10, 1956.

It is the intention of the persons named in the accompanying form of Preferred Stockholders' Proxy to vote such proxies for the election of the four nominees listed below. The Management does not contemplate that any such nominees will be unable to serve as a director for any reason, but if that should occur prior to the meeting, the proxy holders reserve the right to substitute another person of their choice as nominee in his place and stead. In voting for directors, the holders of Preferred Stock are entitled to vote, as a class, to the exclusion of all other classes of stock.

The plan of reorganization hereinafter described upon which shareholders are being asked to vote at this meeting, if adopted, will eliminate the preferred stock and as a consequence its right to elect not more than one-third of the Board of Directors. However, it is the intention of the following named directors to continue to serve thereafter until the end of their terms or until their successors are elected.

INFORMATION ABOUT NOMINEES AND DIRECTORS TO BE ELECTED BY PREFERRED STOCKHOLDERS

Name of Nominee	Principal Occupation	Served as Director Since	Shares of Preferred Stock Owned Beneficially as of June 1, 1957	Shares of Common Stock Owned Beneficially as of June 1, 1957
R. E. Nye	Retired, Webster Groves, Missouri.	1946-52 and 9/10/56 to date	250	None
Carl M. Shinn	Attorney at Law, Lamar, Colorado.	9/10/56 to date	None	None
Cyril C. Slapnicka	Scout, Cleveland Indians Baseball Club, Cedar Rapids, Iowa.	9/10/56 to date	1,000	None
Gus Wolfe	Certified Public Accountant, Neodesha, Kansas.	7/26/55 to date	400	None

[1] The substantial reduction in holdings of these directors was occasioned by their exchange of shares for units of Grain Elevator Warehouse Company in July, 1956.

SECTION 2. REMUNERATION OF DIRECTORS AND OFFICERS

During the fiscal year ended April 30, 1957, no officer or director of the Company received in excess of $30,000 as direct aggregate remuneration. During said period, all officers and directors as a group received the sum of $87,400.12 as such remuneration. This does not include $4,800 paid to the law firm of Davis, Marshall & Crumlish, 1342 Fidelity-Philadelphia Trust Building, Philadelphia, Pa., of which James J. Davis, Vice-President and director, is a partner and as such receives a portion of the fees paid. Directors as such received no compensation during the fiscal year ended April 30, 1957.

SECTION 3. INTEREST OF MANAGEMENT AND OTHERS IN CERTAIN TRANSACTIONS

Purchase of Assets of Saunders Mills, Inc.

Grain Elevator Warehouse Company, a Delaware Corporation, the holder of more than 10% of the outstanding equity securities of the Company is also the owner of 100% of the outstanding securities of Saunders Mills, Inc., an Ohio Corporation. On February 8, 1957, the Board of Directors entered into an agreement for the purchase of all of the physical assets of Saunders Mills, Inc., comprising alfalfa dehydrating plants and field equipment and related items located at Toledo, Ohio; Stand, Missouri; Steel, Missouri; Big Bend, Colorado; May Valley, Colorado; Gibbon, Nebraska; Ord, Nebraska; Jerome, Idaho; Homedale, Idaho; Calipatria, California and Calexico, California. These facilities were acquired by the Company for a consideration of $480,000 in cash and the issuance by the Company of its 5-year note in the amount of $720,000 with interest at 5% per annum. Under the terms of said note, the Company has the right to prepay any amount at any time within said period.

This acquisition added 20 dehydrating drums to the Company's production capacity which would increase the Company's capacity by approximately 50,000 tons per year. In addition thereto, it gave the Company production facilities in areas where the Company could be more competitive with other producers in the eastern markets with the concomitant saving of freight rates to those areas. Grain Elevator Warehouse Company had acquired 100% of the outstanding stock of Saunders Mills, Inc., in January, 1957, paying therefor $199,600 in cash and issuing to the former stockholders of Saunders Mills, Inc., $200,000 principal amount of its 5% Convertible Subordinated Debentures due 1976 and 23,400 shares of the common stock of National Alfalfa Dehydrating and Milling Company, which it had held in its treasury, and which had a market value on the date of acquisition of $11.25 per share.

Of the purchase price paid, Mr. Clarence M. Saunders, now a director of the company, received, as agent for himself and minor children all of said consideration except 5,400 shares National Alfalfa Dehydrating and Milling Company and $50,000 principal amount Grain Elevator Warehouse Debentures.

During the last fiscal year the following options heretofore held on the stock of National Chlorophyll and Chemical Company (now Hofmann Industries) were exercised by Henry A. Hofmann, president: 200 shares at $3 per share and George Kohler, an employee, 500 shares at $5 per share. The market value on the dates when each of these options was exercised was 4 and 3¾ respectively. There are no options outstanding on any shares of the Company or any of its affiliates, all options heretofore granted having been exercised or released.

Grain Elevator Warehouse Company, a Delaware Corporation, purchased from the company a gas storage facility located at Garden City, Kansas, for a sum of $418,000, and the issuance to the company of a warrant to purchase 100,000 shares of the common stock of that company at $1 per share. The profit to the company as reflected in the financial statements was $199,752 after provision for Federal income taxes of $105,800. The facility was then leased to the Company

and used during the fiscal year ending April 30, 1937. Rentals paid under this arrangement for the fiscal year ended April 30, 1937, were $67,814.12, the rates being based on Commodity Credit Corporation rates in existence at the time.

National Alfalfa Dehydrating and Milling Company by reason of its ownership of a warrant to purchase 100,000 shares of the common stock of Grain Elevator Warehouse Company would own approximately 45% of its equity securities and officers and directors of the Company do not, to the best of the knowledge of the management, own more than 20% thereof.

The present value of the common stock of Grain Elevator Warehouse Company in the over-the-counter market is bid 6½ asked 8.

SECTION 4. MODIFICATION OF SECURITIES

The Board of Directors of the Company on April 8, 1937, adopted a resolution proposing a reorganization of the Company's capital structure for submission to the vote of the stockholders of the Company. A vote of 66⅔% of the outstanding stock both 5% Cumulative Preferred Stock and Common Stock each voting as a class are required under the laws of the State of Delaware for approval of said plan of reorganization.

The plan would require preferred stockholders to surrender their stock for exchange on the basis of one share of preferred stock for one $30 5% Debenture Bond of the Company due July 1, 1975. These bonds would be dated as of August 1, 1937, and would bear interest semi-annually on January 1 and July 1 in each year. The bonds would be issued pursuant to an Indenture entered into by and between the Company and Fidelity-Philadelphia Trust Company, 123 South Broad Street, Philadelphia, Pennsylvania, Trustee, under said Indenture.

The 5% Cumulative Preferred stockholders in addition thereto in lieu of dividend arrears accumulated on said 5% Cumulative Preferred stock which as of July 1, 1937, amounted to $10 per share, would receive for each share of 5% Cumulative Preferred stock held one warrant evidencing their right to subscribe to one-half share of common stock of the Company at a price of $10 per share. Said warrant to expire on July 1, 1969, unless said bond issue or any part remains outstanding beyond said date in which event it shall expire when all bonds have been redeemed. The warrants may be combined with other like warrants and subscriptions will be accepted for full shares only. No fractional shares will be issued, as provided in the Indenture.

If the plan of reorganization is approved, restrictions on dividends on common stock of the Company will be governed by the Indenture and the present restrictions on dividends on common stock as set forth in the Preferred stock will be eliminated as well as all voting rights of the Preferred stock which may at present, because of the arrearage, elect not more than one-third of the Board of Directors.

The market value of the common stock on the American Stock Exchange and of the Preferred stock in the over-the-counter market was as follows:

	May 1-July 30		*July 31-Oct. 29*		*Oct. 30-Jan. 30*		*Jan. 31-April 30*		*June 12, 1937*
	High	*Low*	*High*	*Low*	*High*	*Low*	*High*	*Low*	
Preferred									
Bid	25	22	25	22	27	22	30	25	31
Ask	30	25	30	25	29	25	35	27	
Common	10⅞	9¼	10½	8¼	11⅜	8⅛	10⅞	8½	9⅛

Description of the Debentures

The Debentures are to be issued under an Indenture (The "Indenture"), dated as of July 1, 1937, between the Company and Fidelity-Philadelphia Trust Company as Trustee (The "Trustee"). A copy of the form of Indenture is filed with the Securities and Exchange Commission pursuant to the Trust Indenture Act of 1939. The following statements are summaries of certain provisions contained in the Indenture and terms defined therein are used in such statements. They do not purport to be complete statements of all the terms and provisions of the Indenture and reference is hereby made to the Indenture for full and complete statements of such terms and provisions, to all of which the following statements are subject.

The Debentures are direct obligations of the Company, but are not secured.

The Debentures are dated August 1, 1937, and are to mature July 1, 1975, and are to bear interest at the rate of 5% per annum, payable semi-annually on January 1 and July 1 in each year.

The definitive Debentures are to be issuable in registerable form without coupons in denominations of $30, $100 and $1,000 each. The principal amount of Debentures hereunder is limited to $2,352,930. The Indenture contains provisions limiting the amount of other securities which may be issued by the Company and restricting the incurring of additional debt as stated below under the sub-heading Covenants Regarding Liens, Indebtedness, etc.

Debentures in an aggregate principal amount not exceeding $2,352,950 may be executed by the Company and delivered to the Trustee for authentication and shall thereupon be authenticated and delivered by the trustee to or upon the written order of the Company in exchange for shares of 5% Cumulative Preferred Stock on a basis of one share of preferred stock for each $50 Debenture bond. There will be no proceeds from the issuance of the Debentures.

In the Indenture, the Company has covenanted to pay principal and interest without deduction for the Pennsylvania Corporate Loans Tax or any substitute therefor, up to four mills that the Company may be required to pay or retain and to reimburse the owner of any Debenture for any personal property tax, up to four mills, lawfully imposed upon and paid by such owner by reason of any present or future law of the Commonwealth of Pennsylvania or any political sub-division thereof if claim for such reimbursement is made as prescribed in the Indenture.

Subordination

The Debentures are subordinate to all bank loans for inventory purposes and obligations of the Company to suppliers of materials, services and labor incurred in the normal course of business. In addition thereto, the Debentures are subordinate to indebtedness created in a manner as set forth under the sub-heading Covenants Regarding Liens, Indebtedness, etc.

Redemption Provisions

The Debentures are redeemable at the option of the Company, as a whole or in part, from time to time, on at least 60 days published notice after July 1, 1958, and prior to July 1, 1975, at 100% of par, plus accrued interest to the date of redemption.

Sinking Fund Provisions

The Company will pay to the Trustee annually commencing ninety days after April 30, 1959, as and for a contingent sinking fund for the redemption of Debentures at 100% with interest accrued to the date fixed for redemption an amount which shall be the lesser of the sum sufficient to redeem $196,080 principal amount of Debentures or an amount equal to 100% of the consolidated net earnings for the next preceding fiscal year of the Company. The Company will accrue 100% of the net earnings of the Company commencing on May 1, 1957, and set aside such sum in order to be able to meet the sinking fund provisions. If in any year 100% of the net earnings does not equal $196,080, such deficiency will accrue against future earnings of the Company and shall be paid over to the Trustee in such future years in order that 1/12th of the entire amount of the issue shall be retired for each year subsequent to April 30, 1959.

The Company reserves the right to purchase in the open market Debentures for sinking fund purposes.

Covenants Regarding Liens, Indebtedness, Etc.

The Indenture provides that the Company will not create any lien upon any property owned directly by the Company which shall secure any other indebtedness and which shall not equally and ratably secure the Debentures except:

(a) Existing liens, mortgages, conditional sales contracts and other indebtedness on property purchased or owned at the date of this Indenture.

(b) Purchase money liens on property hereafter acquired where such liens represent no more than 60% of the fair market value or purchase price of the property as determined by the Board of Directors and the aggregate of such liens so created does not exceed $1,200,000.

(c) Liens on inventory in connection with the Company's seasonal credit maturing by its original terms in not more than 12 months from the date of the creation thereof.

(d) Renewals, extensions or replacements of any lien mentioned in the foregoing clauses (a), (b) and (c).

The Company may create funded indebtedness secured by mortgages or liens or other forms of security agreements upon its property by and with the consent of the holders of [illegible] of the Debentures at the time outstanding.

The Company covenants in the Indenture that it will not sell, transfer or lease its property as an entirety or substantially as an entirety or consolidate or merge with any other corporation unless such corporation be a wholly-owned subsidiary, or as a result thereof any of the property of the Company would become subject to any encumbrances other than any to which the property was then at once subject, unless the Company, prior thereto, shall secure the Debentures either alone or equally and ratably with any other indebtedness of the Company by a direct lien on all such property of the Company prior to all liens other than any therefore existing thereon.

Covenants Regarding Dividends

The Indenture provides that the Company will not pay dividends on any shares of stock in the Company while a default under the Indenture exists, either in the payment of interest on Debentures or in the operating of the sinking fund provisions of the Indenture.

Modification of the Indenture

With the consent of the holders of not less than 66⅔% in principal amount of the Debentures at the time outstanding, the Company and the Trustee may enter into supplementary indentures adding any provisions to, or changing or eliminating any provisions of, the Indenture, but no supplemental indenture shall (a) reduce the principal amount or extend the fixed maturity of any Debenture, or reduce the rate or extend the time of payment of interest, or reduce the percentages of Debentures, the consent of the holders of which is required to approve any supplemental indenture, without the consent of the holders of all Debentures then outstanding.

Defaults and Notice Thereof

The following are defined in the Indenture as events of default: failure to pay principal when due; failure for 30 days to pay interest or any sinking fund instalment when due; failure to perform certain covenants outlined in the Indenture for 60 days after notice; default under other indebtedness, continued beyond the period of grace; certain events in bankruptcy, insolvency, or reorganization, or the suffering of a judgment exceeding $100,000 not discharged or appealed within the period specified in the Indenture.

The Trustee is required, within stated periods after the occurrence of an event of default known to it and remaining uncured, to give to the Debenture holders notice thereof; provided, that except in the case of default in the payment of any principal of, or interest on, any of the Debentures, or, of any sinking fund instalment, the Trustee shall be protected in withholding such notice if and so long as it determines in good faith, that the withholding of such notice is in the interest of the Debenture holders.

Rights Upon Default

If an event of default shall occur, either the Trustee or the holders of not less than 20% in aggregate principal amount of outstanding Debentures may declare the principal of all Debentures due immediately, but the holders of a majority in aggregate principal amount of all outstanding Debentures may, subject to the conditions set forth in the Indenture, waive such default or defaults and rescind and annul such declaration and its consequences.

The holders of a majority in aggregate principal amount of all outstanding Debentures may direct the time, method and place of conducting any proceeding for any remedy available to the Trustee or of exercising any trust or power conferred upon the Trustee and may, on behalf of the holders of all of the Debentures, waive any past default and its consequences; provided that any default in payment of principal or interest may be waived only upon the conditions specified in the Indenture.

Satisfaction and Discharge of the Indenture

The Indenture provides that it shall terminate if (a) all Debentures not theretofore cancelled shall have been delivered to the Trustee for cancellation, or (b) when all the Debentures shall have become due, the Company shall pay the whole amount of the principal and interest due upon all the Debentures, or shall deposit with the Trustee for the payment of the Debentures the entire amount then due for principal and interest, or (c) prior to all of the Debentures having become due, the Company shall deposit with the Trustee an amount sufficient to pay or redeem all Debentures at the time outstanding and in any such event the Company shall also pay all other sums payable under the Indenture and by the Company and shall furnish the Trustee with the certificate and opinion required by the Indenture as to compliance with conditions precedent. The Indenture also provides that in such event the Trustee on demand and at the cost of the Company shall execute proper instruments acknowledging satisfaction of and discharging the Indenture.

Certificates, Opinion and Reports to Trustee

The Indenture provides that the Company will furnish to the Trustee a certificate of certain officers of the Company and an opinion of counsel as to compliance with the conditions precedent to the satisfaction and discharge of the Indenture or to any other action to be taken by the Trustee at the request of the Company.

The Indenture requires the Company to file annually with the Trustees a statement of Independent Public Accountants, who examined the financial statements of the Company and its subsidiaries, if any, as to defaults, if any, by the Company in the observance of certain of the covenants of the Indenture relating to financial and accounting matters.

The Indenture requires the Company to file with the Trustee copies of its annual reports and of the information, documents and other reports of the Company which may be required to file with the Securities and Exchange Commission pursuant to Section 13 or Section 15 (d) of the Securities Exchange Act of 1934, together with such additional information, documents and reports with respect to compliance by the Company with the conditions and covenants provided for in the Indenture as may be required from time to time by the rules and regulations of the Commission.

Concerning the Trustee

The Fidelity-Philadelphia Trust Company is to be the Trustee under the Indenture. The Trustee has been one of the banks participating in the Company's seasonal credit line for inventory purposes.

The Indenture provides that if the Trustee acquires any conflicting interest, as defined therein, the Trustee, within 90 days after ascertaining the conflicting interest, shall either eliminate such conflicting interest or resign. The Indenture provides that the Trustee shall, prior to the occurrence of an event of default and after the curing of all events of default which have occurred, perform only such duties as are specifically set forth in the Indenture. During the existence of any event of default, the Trustee shall exercise such of the rights and powers vested in it under the Indenture, and use the same degree of skill and care in their exercise, as a prudent man would exercise or use under the circumstances in the conduct of his own affairs.

The Trustee, in its individual capacity, may become the owner or pledgee of Debentures with the same rights it would have if it were not Trustee.

Description of Warrants

The warrants to be issued in lieu of dividend arrearage which shall be received by the holders of the 5% Cumulative Preferred Stock shall be issued by the Company and shall be transferable by the holders thereof by endorsement thereon. The warrants shall evidence the right to subscribe to one-half share of common stock of the Company at a price of $10 per share and shall be valid until July 1, 1969, or until said Debenture issue is retired in full, whichever is later.

Said warrants shall not be entitled to participate in any dividends declared or paid on the common stock of the Company nor shall said warrants be entitled to any pre-emptive right. Said warrants shall not prohibit the Company from issuing additional shares of common stock for cash or other property as may be determined by the Board of Directors and as provided in the Articles of Incorporation of the Company, provided that the price for which said common stock is issued is not less than the subscription price of stock in said warrants, in which event the subscription price therein shall be reduced to such price.

Description of Common Stock

The common stock is entitled to one vote per share upon all corporate matters including the election of directors and on liquidation of each share participates pro-rata, whether the liquidation is voluntary or involuntary in the net assets remaining after the payment of all indebtedness.

The common stock is entitled to dividends when and as declared and set aside by the Board of Directors. The common stock does not have any pre-emptive right to subscribe to any present or future issues of stock of any class and no conversion rights, nor are there any redemption or sinking fund provisions relative thereto. The common stock is issued fully paid and non-assessable and is not liable to any further calls or assessments by the Company, and has a par value of $3.00 per share.

Description of 5% Cumulative Preferred Stock

The 5% Cumulative Preferred Stock is entitled to cumulative dividends at the rate of 5% per annum, payable quarterly. No dividends can be declared or paid upon the common stock unless and until all dividends theretofore due upon the preferred stock, plus an amount sufficient to pay the next quarterly dividend to become due upon the preferred stock, has been paid or set aside, nor until the consolidated net earnings of the Company and its subsidiaries, if any, earned subsequent to May 1, 1946, is at least equal to the sum of all dividends paid in cash by the Company since its organization on any of the capital stock of the Company plus $300,000.

The preferred stock is redeemable (other than through the sinking fund), in whole or in part at any time or from time to time, if redeemed prior to December 1, 1953, at $52 per share; if redeemed thereafter but on or prior to December 1, 1953, at $51.50 per share, and if redeemed thereafter at the price of $51 per share, together, in all cases, with dividends accrued thereon to date of redemption.

The preferred stock may be redeemed through the operation of the sinking fund which redemptions are accomplished as follows: The Company is required to set aside as a sinking fund for the preferred stock a sum equal to 20% of the consolidated net earnings of the Company and its subsidiaries, for the proceeding fiscal year, such sum to be so set aside on September 1st of each year. The Company has the right to surrender to the sinking fund, shares of preferred stock acquired by it at public or private sale at the Company's cost, not, however, in excess of the then applicable redemption price above specified and take credit for such redemptions against the then sinking fund requirements. All preferred stock cancelled and redeemed in excess of the then sinking fund requirements may be used as a credit against future sinking fund payments.

As of June 1, 1957, the Company has available for future sinking fund requirements, a credit of $367,327.13 with the sinking fund trustee representing the cost of preferred stock retired in excess of sinking fund requirements. The Company has reduced its authorized capital stock to the extent of the redemption heretofore made so that as of June 1, 1957, there are outstanding 47,059 shares of 5% Cumulative Preferred Stock.

In the event of any voluntary liquidation, dissolution or winding up of the affairs of the Company, the owners of the preferred stock are entitled to receive the full par value of their shares plus the then applicable redemption premium plus all dividends accrued and unpaid to the date of redemption, but in the case of involuntary liquidation, the holders of preferred stock are entitled to receive the par value of their shares without premium plus accrued dividends to date of redemption.

Every share of stock of the Company regardless of class has equal voting rights, except in the case of the preferred stock, the consent of at least 66⅔% of the outstanding preferred stock is necessary to validate or permit an increase in the amount of preferred stock, the voluntary dissolution of the Company, any amendment which would adversely affect the rights or preferences of the preferred stock, and, with certain exceptions, the creation or assumption by the Company or any subsidiary of funded debt; funded debt being defined as any indebtedness maturing by its terms more than 12 months from the date of the original creation or which is extendable or renewable at the option of the obligor to a date more than 12 months from the date of its original creation. Furthermore, the consent of at least 50% of the outstanding preferred stock is required to validate or permit merger, sale, lease or conveyance by the Company of all or substantially all of its assets, disposition of shares of a subsidiary so that it ceases to be such, purchase of preferred stock, otherwise than on tenders, when arrearage exists in the dividends on the preferred stock. It is further to be noted that in the event dividends upon preferred stock are in arrears for six quarterly dividend payments, whether or not consecutive, then the holders of preferred stock voting as a class are entitled to elect ⅓ of the entire Board of Directors until all arrearages have been paid.

As of June 1, 1957, the arrearage on the preferred stock was $10 and therefore, the preferred stock voting as a class are entitled to elect ⅓ of the entire Board of Directors or 4 members as the Board is presently constituted, or contemplated by the by-law amendment to be voted upon at the meeting.

The preferred stock does not have any pre-emptive right to subscribe to any present or future issue of stock of the Company whether now or hereafter authorized. The preferred stock has no conversion rights. All of the preferred stock is issued full paid and non-assessable.

SECTION 5. AMENDMENT OF CHARTER AND EXCHANGE OF SECURITIES

On March 29, 1957, Wright J. Small and Grain Elevator Warehouse Company entered into an agreement under the terms of which the 5% Cumulative Preferred Stock owned by them aggregating 23,060 shares of said preferred stock and constituting in excess of 49% of the outstanding shares were deposited with the Chase Manhattan Bank, New York, N. Y. The parties thereto have agreed to vote in favor of the reorganization plan as submitted herewith.

If the plan proposed by the management for the exchange of one share of Preferred stock for one $30 5% Debenture due 1975 and a warrant to purchase one-half share of common stock is approved by the stockholders by 66⅔% of such stockholders entitled to vote at the annual meeting in each case voting as a class, the Articles of Incorporation of the Company will be amended to eliminate all those paragraphs dealing with the Preferred stock including those provisions setting forth the rights, duties, privileges, limitations and restrictions in favor of said Preferred stock and the Preferred stock shall cease to exist subject only to the right to exchange in accordance with the plan as set forth herein. The Company is advised by counsel that the statutory right of appraisal does not obtain as to dissenting stockholders, and upon approval the exchange will be binding on all stockholders. In the event that shareholders holding in the aggregate more than 5% of the Preferred stock dissent from said plan and vote in the negative at the annual meeting, the management reserves the right to reconsider said action.

In connection with the exchange as proposed herein, the Company has obtained a ruling from the Commissioner of Internal Revenue dated May 29, 1957, under the terms of which it is set forth that as to common stock being exchanged, no gain or loss will be realized by the holder thereof on such exchange, but as to Preferred stock being exchanged, gain or loss will be realized by the holder thereof based upon the market value of the securities received in exchange and that such gain will constitute capital gain or loss as the case may be.

The shareholders under Resolution No. 3 are being asked to approve in subsection (b) thereof the execution of an indenture which would create the issue of $2,352,950 of Debentures in order to effectuate the plan, in subsection (d), an amendment to the Certificate of Incorporation to reflect the retirement of the Preferred stock of the Company and the change in par value of common stock from $1.00 to $3.00 per share and the transfer from paid-in-surplus to capital of $1,500,000 to reflect the change in par value of common stock. Management is requesting these changes in order to strengthen the Company's financial position and to enhance its borrowing powers to meet its expanded needs as a result

its expansion into the eastern markets with the concomitant increase in the amount of borrowing necessary on a seasonal basis to finance its increased productive capacity.

Item 4 will increase the Board of Directors from 12 to 13 and its effect will be to permit an additional director who comes to the Company with wide experience in the industry, Mr. Clarence M. Saunders, hereinbefore named.

SECTION 6. FINANCIAL STATEMENTS

The financial statements included in the annual report enclosed herewith are incorporated by reference in this proxy statement. They consist of the balance sheet of the Company as of April 30, 1957, and related statements of Profits and Loss and Earnings for the three years then ended, all as reported on by Peat, Marwick, Mitchell & Company.

SECTION 7. OTHER MATTERS

The Management is not aware of any other matters which may come before the meeting. However, if any other matters properly come before the meeting, it is the intention of the persons named in the accompanying form of Proxy to vote the Proxy in accordance with their best judgment on such matters.

By Order of the Board of Directors,
L. R. POLLOCK, *Secretary*.

June 21, 1957

Please Note These Corrections

ON PAGE 2

Paragraph 4, line 4, should read:

"ers of record at the close of business on June 21, *1957*, may vote at the meeting."

Under the heading, SECTION 1. RESPECTING THE ELECTION OF DIRECTORS, Paragraph 1, line 5, should read:

"rectors on February 8, *1957*."

ON PAGE 3

Under INFORMATION ABOUT NOMINEES AND DIRECTORS

Clarence M. Saunders has served continuously as Director since *2/8/57*.

STIPULATION EXHIBIT 21

Specimen Form of 5% Cumulative Preferred Stock Certificate.

No. LC 00000

_____ Shares

National Alfalfa Dehydrating and Milling Company

INCORPORATED UNDER THE LAWS OF THE STATE OF DELAWARE.

5% CUMULATIVE PREFERRED STOCK

THIS IS TO CERTIFY that _____

is the owner of _____ fully paid and non-assessable shares of 5% CUMULATIVE PREFERRED STOCK of the par value of $50. per share of

National Alfalfa Dehydrating and Milling Company

(hereinafter called the "Corporation"), transferable on the books of the Corporation by the holder hereof in person or by duly authorized attorney upon surrender of this Certificate properly endorsed.

A statement of the designations, preferences and relative, participating, optional or other special rights of each class of stock and the qualifications, limitations or restrictions of such preferences and/or rights, fixed by the Certificate of Incorporation, as amended, is printed on the reverse hereof, and this Certificate and the shares represented hereby are issued and shall be held subject to all of the provisions of the Certificate of Incorporation and all certificates amendatory thereof or supplemental thereto (copies of which are on file with the Transfer Agent), to all of which the holder, by acceptance hereof, assents.

This Certificate is not valid unless countersigned by the Transfer Agent and registered by the Registrar.

WITNESS the facsimile seal of the Corporation and the facsimile signatures of its duly authorized officers.

Dated _____

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY CORPORATE SEAL 1946 DELAWARE

S.P. Chase ex
Secretary

Henry S.P. Chase min
President

REGISTERED:
CITY BANK FARMERS TRUST COMPANY, Registrar.
By
Authorized Officer.

COUNTERSIGNED:
THE NATIONAL CITY BANK OF NEW YORK, Transfer Agent.
By
Authorized Officer.

CITY BANK FARMERS TRUST COMPANY

REGISTRAR

CORPORATE SEAL 1940 DELAWARE

[*The reverse side of the specimen certificate is omitted since the statement of designations and the powers, preferences, and rights in respect of the 5% Cumulative Preferred Stock set forth thereon is also contained in the Composite Certificate of Incorporation, Stipulation Exhibit 22,* infra.]

STIPULATION EXHIBIT 22

Composite Certificate of Incorporation.

(186)

Composite
Certificate of Incorporation

OF

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY

(DELAWARE)

THE W. H. SIBLEY STAT'Y CO. LONDON

Composite

Certificate of Incorporation

OF

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY

FIRST: The name of this corporation is NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY (hereinafter called the "Corporation").

SECOND: Its principal office in the State of Delaware is located at 100 West Tenth Street, in the City of Wilmington, County of New Castle. The name and address of its resident agent is The Corporation Trust Company, 100 West Tenth Street, City of Wilmington, County of New Castle.

THIRD: The nature of the business, or objects or purposes to be transacted, promoted or carried on, are:

To buy, raise, acquire, handle, store, process, cure, dehydrate, mill, sell and generally deal in and with grain, flour, feed, farm produce of any and all kinds and mill and other products that may be related to the production of, or may be manufactured from or used in connection with, farm produce of any and all kinds; to manufacture and sell any and all products that may, in whole or in part, be manufactured from or used in connection with grains or other farm produce of any kind; to do a general milling, processing and manufacturing business in grains and other farm produce; to manufacture, produce, buy, sell, distribute and generally deal in food, forage, cereal products and the ingredients of any thereof; to acquire, build, buy, sell, lease, own and operate mills, processing plants, elevators, storage bins, cribs, warehouses and other storage properties, machinery, apparatus, equipment, devices and appliances of every kind and description, and all parts, supplies and accessories therefor.

FOURTH: The total number of shares of all classes of stock which the Corporation shall have authority to issue is 819,369 shares, of which 56,369 shares are to be 5% Cumulative Preferred Stock of the par value of $50 per share, and 763,000 shares are to be Common Stock of the par value of $1 per share.

The minimum amount of capital with which the Corporation will commence business will be $1,000.

The following is a statement of the designations and the powers, preferences and rights, and the qualifications, limitations or restrictions thereof, in respect of the classes of stock of the Corporation.

5% CUMULATIVE PREFERRED STOCK

Dividends

1. The holders of the 5% Cumulative Preferred Stock (sometimes referred to herein as the "Preferred Stock") shall be entitled to receive, if, when and as declared by the Board of Directors out of any funds legally available for the declaration of dividends, cumulative, preferential cash dividends at the rate of 4½% per annum on the par value thereof, and no more, to September 1, 1946, and thereafter at the rate of 5% per annum on the par value thereof, and no more, in each case, payable quarterly on the 1st days of March, June, September and December in each year, commencing September 1, 1946. Such dividends on shares of Preferred Stock shall be cumulative from and including June 1, 1946.

The term "dividends accrued", whenever used herein with reference to any shares of the Preferred Stock, shall be deemed to mean an amount computed at the rate of 4½% per annum on the par value thereof from and including June 1, 1946 to September 1, 1946, and at the rate of 5% per annum on the par value thereof from and including September 1, 1946 to the date to which dividends are stated to be accrued thereon less the aggregate of the dividends theretofore and on such date paid thereon. Shares of Preferred Stock at any time owned by the Corporation shall, for the purposes of this definition, be deemed to have received the dividends paid on all outstanding shares of Preferred Stock which were not so owned at the time as of which stockholders entitled to such dividends were determined.

2. (a) So long as any of the Preferred Stock shall be outstanding, no dividend whatsoever, whether in cash, stock or otherwise, shall be paid or declared, nor shall any distribution be made on the Common Stock or on shares of any other class of stock of the Corporation not ranking prior to or on a parity with the Preferred Stock, nor shall any shares of such subordinate stock be purchased, redeemed or otherwise acquired for a valuable consideration by the Corporation or any of its subsidiaries, nor shall any moneys be paid to or set aside or made available for a sinking fund for the purchase or redemption of any such subordinate stock unless

(i) all dividends on the Preferred Stock for all past quarterly dividend payment dates shall have been paid and the full dividends for the next quarterly dividend payment date shall have been paid, or declared and a sum sufficient for the payment thereof set apart; and

(ii) all amounts then or theretofore required to be set aside as and for the sinking fund for the Preferred Stock shall have been set aside and all defaults, if any, in complying with such sinking fund requirements in respect of previous years shall have been made good.

(b) So long as any of the Preferred Stock shall be outstanding, no dividend (other than a dividend payable in shares of stock of the Corporation of a class not ranking prior to or on a parity with the Preferred Stock) shall be paid or declared, nor shall any distribution be made on the Common Stock or on the shares of any other class of stock of the Corporation not ranking prior to or on a parity with the Preferred Stock, nor shall any shares of such subordinate stock be purchased, redeemed or otherwise acquired for a valuable consideration by the Corporation or any of its subsidiaries, nor shall any moneys be paid to or set aside or made available for a sinking fund for the purchase or redemption of any such subordinate stock unless, after giving effect to such action, the consolidated net earnings of the Corporation and its subsidiaries, computed as hereinafter in this subdivision provided, earned subsequent to May 1, 1946 shall be at least equal to the sum of clauses (i), (ii) and (iii), as follows:

(i) the aggregate of all dividends (other than dividends

payable in shares of stock of the Corporation of a class not ranking prior to or on a parity with the Preferred Stock) paid or declared and all distributions made by the Corporation in respect of stock of any class of the Corporation at any time after the date of its incorporation, including all amounts paid in respect of or as dividends accrued, directly or indirectly, whether on redemption of any shares of stock of the Corporation or through the operation of any sinking fund or otherwise;

(ii) the excess of (x) the aggregate of all amounts expended by the Corporation or any of its subsidiaries for the purpose of purchasing, redeeming or otherwise acquiring shares of stock of the Corporation of any class not ranking prior to or on a parity with the Preferred Stock, and all amounts paid to or set aside or made available for a sinking fund for the purchase or redemption of any such subordinate stock over (y) the net cash proceeds received by the Corporation from the issue or sale, subsequent to June 1, 1946, of shares of stock of the Corporation of any class not ranking prior to or on a parity with the Preferred Stock (exclusive of any such subordinate shares which may be issued on the exercise of any warrants pursuant to subdivision II hereof or on the conversion of shares of stock of any class ranking prior to or on a parity with the Preferred Stock); and

(iii) an amount equal to the lesser of $300,000 or the amount calculated at the rate of $200,000 per annum from May 1, 1946 to the date as of which such calculation is being made.

As used in this subdivision, the term "consolidated net earnings" shall mean the balance remaining after deducting from the consolidated earnings and other income and profits of the Corporation and its subsidiaries all expenses and charges of every proper character, including interest, amortization of debt discount and expense, taxes, reasonable provision for depreciation, amounts appropriated under any plan of the Corporation or any subsidiary for extra compensation for, or pension of, officers and employees, provision for net profits applicable to minority interests in subsidiaries and proper reserves determined in good faith by the Board of Directors of the Corporation in its discretion, all based upon a statement of income and profit and loss consolidating the accounts of the Cor-

poration and its subsidiaries prepared in accordance with generally accepted principles of accounting, provided, however, that in computing consolidated net earnings, (i) losses from the abandonment or writing off of any assets or profits or losses from the sale of capital assets (including securities of other corporations) shall be disregarded, (ii) adjustments of earnings of any previous period charged or credited to surplus account of the Corporation or any subsidiary shall be excluded, (iii) write-downs or write-ups of capital assets (including securities of other corporations) shall be disregarded, and (iv) no deduction shall be made in respect of dividends declared or paid on any class of stock of the Corporation.

Redemption Other Than Through Sinking Fund.

3. (a) The Corporation may, at its option (which may be exercised upon authorization by the Board of Directors), redeem the Preferred Stock at the time outstanding, as a whole at any time, or in part from time to time, by giving notice as herein provided and by paying or providing for the payment in cash of the following redemption prices per share: if redeemed on or prior to December 1, 1949, $53; if redeemed thereafter but on or prior to December 1, 1951, $52.50; if redeemed thereafter but on or prior to December 1, 1953, $52; if redeemed thereafter but on or prior to December 1, 1955, $51.50; and if redeemed thereafter, $51; plus in each case dividends accrued thereon to the date fixed for such redemption. In case of the redemption of only part of the Preferred Stock at the time outstanding, the shares to be redeemed shall be selected pro rata or by lot or in such other manner as the Board of Directors may determine. Subject to the provisions and limitations herein contained, the Board of Directors shall have full power and authority to prescribe the manner in which, and the terms and conditions upon which, such stock shall be redeemed from time to time.

(b) Notice of every such redemption of Preferred Stock shall be mailed to the holders of record of the shares of Preferred Stock to be redeemed at their last known post-office addresses, as shown by the records of the Corporation, and shall be so mailed at least 30 days and not more than 60 days prior to the date fixed for redemption.

(c) If notice of redemption shall have been duly mailed as above provided, and if on or before the redemption date designated in such notice the funds necessary for such redemption shall have been set aside so as to be and continue to be available therefor, then notwithstanding that any certificate of such Preferred Stock so called for redemption shall not have been surrendered for cancellation, the dividends thereon shall cease to accrue from and after the date of redemption so designated and all rights with respect to such Preferred Stock so called for redemption shall forthwith on such redemption date cease and determine, except only the right of the holder to receive the redemption price therefor plus all dividends accrued thereon to the date fixed for redemption, but without interest; or if notice of redemption of any of such Preferred Stock shall have been duly mailed as above provided, and if on or before the redemption date designated in such notice the Corporation shall deposit, with any bank or trust company either in The City of New York, State of New York, or in the City of Denver, State of Colorado, and having a capital and undivided surplus aggregating at least $2,000,000 and named in such notice, funds sufficient to redeem such Preferred Stock upon the date designated in the notice of redemption, in trust to be applied to the redemption of the Preferred Stock so called for redemption, then forthwith on the date of such deposit all rights of the holders of the Preferred Stock so called for redemption, as stockholders of the Corporation, shall cease and determine, except only the right to receive the moneys so deposited, but without interest. Any interest accrued on such funds shall be paid to the Corporation from time to time. Any funds so set aside or deposited, as the case may be, and unclaimed at the end of 6 years from such redemption date, shall be released and repaid to the Corporation, and any holder of shares of Preferred Stock so called for redemption who shall not have received the redemption price for such shares, with the dividends accrued thereon, prior to such release and repayment shall, as of such date of release and repayment, have only a general claim against the Corporation as an unsecured creditor for the redemption price and dividends accrued to the date fixed for redemption.

Sinking Fund.

4. (a) Commencing with the year 1947, there shall be a sink-

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ing fund for the benefit of the shares of the Preferred Stock, and shares of Preferred Stock shall be subject to redemption through the operation of such sinking fund as hereinafter provided. So long as there shall remain outstanding any Preferred Stock, the Corporation shall set aside on or before September 1, 1947, as and for the sinking fund for the then current year an amount in cash equal to 10% of the consolidated net earnings of the Corporation and its subsidiaries from the date of its incorporation to the end of the fiscal year preceding September 1, 1947, and shall set aside on or before September 1, 1948, and annually thereafter on or before each September 1, as and for the sinking fund for the then current year, an amount in cash equal to 20% of the consolidated net earnings of the Corporation and its subsidiaries for the fiscal year next preceding such September 1. Consolidated net earnings of the Corporation and its subsidiaries shall be computed as hereinabove provided in subdivision 2, except that for the purposes of calculations under this subdivision, there shall also be deducted dividends declared or paid on the Preferred Stock. Amounts set aside for the sinking fund shall be deposited in a separate bank account, in trust, for the uses and purposes of the sinking fund as herein provided. So long as dividends on the Preferred Stock for any past quarterly dividend payment date shall not have been fully paid or declared and a sum sufficient for the payment thereof set apart, the date for the setting aside of any annual amounts for such sinking fund as aforesaid may be postponed until all such dividends in arrears shall have been paid or declared and a sum sufficient for the payment thereof set aside, and no such annual amounts need be set aside for such sinking fund while such arrears shall exist.

In addition to the amounts to be set aside annually as aforesaid, all amounts received in cash by the Corporation upon the exercise of any warrant pursuant to subdivision 11 hereof shall forthwith be set aside as an additional payment to the sinking fund and be deposited and applied as hereinafter provided.

(b) If the Corporation shall have acquired any shares of Preferred Stock which are not required to be cancelled, the Corporation shall then be entitled to a credit on account of the then current or any future annual Preferred Stock sinking fund requirement equal to the cost to the Corporation of the shares for which credit is so

taken, including the usual and customary brokerage commissions paid in connection with the purchase thereof, but not exceeding the redemption price (exclusive of dividends accrued) applicable for the redemption of Preferred Stock through the operation of the sinking fund on the sinking fund payment date for which such credit is taken, plus such usual and customary brokerage commissions.

(c) Except as hereinafter in this paragraph (c) provided, any moneys set aside for the sinking fund, as hereinabove required, may be applied from time to time by the Corporation to the redemption of Preferred Stock at the following redemption prices per share (hereinafter sometimes called "sinking fund redemption prices"): if redeemed on or prior to December 1, 1953, $52; if redeemed thereafter but on or prior to December 1, 1955, $51.50; and if redeemed thereafter, $51, plus dividends accrued thereon to the date fixed for redemption. Such moneys may likewise be applied to the purchase, directly or through agents, of Preferred Stock in the open market or at public or private sale, without advertisement or notice, as the Board of Directors shall in its discretion determine at prices not exceeding the then applicable sinking fund redemption price plus dividends accrued thereon and plus the usual and customary brokerage commissions payable in connection with such purchase. If on the 45th day prior to any December 1 there shall remain in the sinking fund for such stock an amount exceeding $25,000, then the Corporation shall promptly select and call for redemption on such December 1 at the then applicable sinking fund redemption price plus dividends accrued thereon to the date fixed for such redemption, such number of shares of Preferred Stock as is necessary to exhaust as nearly as may be all of said moneys. The selection of shares for redemption and the redeeming of any shares of Preferred Stock pursuant to this paragraph shall be made in the manner provided for the redemption of Preferred Stock pursuant to subdivision 3 hereof, but at the sinking fund redemption price then applicable. Anything herein to the contrary notwithstanding, no purchase or redemption of shares of Preferred Stock with any moneys set aside for such sinking fund shall be made or ordered unless full cumulative dividends for all past quarterly dividend payment dates have been paid, or declared and a

sum sufficient for the payment thereof set aside, upon all shares of Preferred Stock then outstanding, except to the extent that any such purchase may be made, as provided in paragraph 9(f) hereof, upon consent of the holders of 50% of the Preferred Stock at the time outstanding or upon request for tenders not requiring any such consent. When no shares of Preferred Stock shall remain outstanding any balance remaining in such sinking fund shall be and become part of, and may be transferred to, the general funds of the Corporation.

Retirement of Shares

5. Shares of Preferred Stock redeemed at the option of the Corporation or purchased or redeemed pursuant to any obligation of the Corporation to purchase or redeem shares through the sinking fund for the Preferred Stock or used as a credit for such sinking fund or surrendered in exchange for Common Stock of the Corporation upon the exercise of any warrant pursuant to subdivision 11 hereof shall not be reissued but shall be cancelled and the authorized capital stock of the Corporation reduced in the manner permitted by law; provided that the Corporation shall not be required more than once in each calendar year to take any proceedings to reduce its authorized capital stock or to take such proceedings at any time when the total number of shares so redeemed or purchased or used as a credit or received on such exchange, with respect to which no proceedings shall have theretofore been taken, shall be less than 500.

Liquidation

6. In the event of any voluntary liquidation, dissolution or winding up of the affairs of the Corporation, the holders of the Preferred Stock shall be entitled to be paid an amount equal to the redemption price then current for the redemption of Preferred Stock at the option of the Corporation, as provided in subdivision 3 hereof, and in the event of an involuntary liquidation, dissolution or winding up of the affairs of the Corporation, the holders of the Preferred Stock shall be entitled to be paid an amount equal to $50 per share, together in each case with dividends accrued thereon to the date fixed for the payment of any such amount, and no more, before any distribution or payment shall be made to the holders of stock of any class not ranking prior to or on a parity with the

Preferred Stock. After payment to the holders of the Preferred Stock of the amounts to which they are entitled as aforesaid, the balance, if any, shall be paid to the holders of stock subordinate to the Preferred Stock according to their respective rights. In case the net assets of the Corporation are insufficient to pay to holders of all outstanding shares of Preferred Stock and to holders of any stock ranking on a parity with the Preferred Stock the full amount to which they are respectively entitled, the entire net assets of the Corporation remaining after providing for any stock which may rank prior to the Preferred Stock shall be distributed ratably to the holders of all outstanding shares of Preferred Stock and the holders of any stock ranking on a parity with the Preferred Stock in proportion to the full amounts to which they respectively are entitled. The consolidation or merger of the Corporation with or into any other corporation or corporations in pursuance of the applicable statutes providing for consolidation or merger shall not be deemed a liquidation, dissolution or winding up of the affairs of the Corporation within the meaning of any of the provisions of this subdivision.

Voting

7. In addition to the voting rights provided for hereinafter in subdivision 15 hereof, the holders of the Preferred Stock shall have the voting rights provided for in subdivisions 8, 9 and 10 hereof.

8. So long as any shares of Preferred Stock are outstanding, the consent of the holders of at least 66-2/3% of the shares of Preferred Stock at the time outstanding, given in person or by proxy either in writing or at a meeting called for that purpose, shall be necessary to effectuate or validate the action of the Corporation in doing or in authorizing or permitting any subsidiary to do, as the case may be, any one or more of the following:

(a) the increase in the authorized amount of Preferred Stock or the authorization or creation of any class of stock of the Corporation ranking on a parity with or prior to the Preferred Stock (whether through the amendment of the rights of an existing class of stock or otherwise) or any increase in the authorized amount of any class of stock of the Corporation ranking on a parity with or prior to the Preferred Stock, or the

authorization or creation of any class of stock of the Corporation or the increase of the authorized amount of such stock or the creation of any obligation which in each of such cases is convertible into or evidences the right to purchase any stock of the Corporation of any class ranking on a parity with or prior to the Preferred Stock;

(b) the voluntary dissolution, liquidation or winding up of the Corporation;

(c) any amendment, alteration or repeal of any of the provisions of the Certificate of Incorporation which would adversely affect the rights or preferences of the Preferred Stock or the holders thereof; or

(d) the creation, issue and sale or assumption by the Corporation or any subsidiary of any funded debt or the giving by the Corporation or any subsidiary of any guarantee or similar obligation for the payment of funded debt; provided, however, that this paragraph (d) shall not apply to

(i) any funded debt issued or sold, or guarantee given, by any subsidiary to the Corporation, but the Corporation shall not, without like vote, dispose of such funded debt or guarantee unless prior thereto, or simultaneously therewith, all stock of such subsidiary owned by the Corporation or any other subsidiary and all other indebtedness of such subsidiary owing to the Corporation or another subsidiary is sold or disposed of;

(ii) any funded debt incurred for the purpose of extending, renewing or refunding any funded debt of the Corporation or a subsidiary in a principal amount not more than the then principal amount of the funded debt so extended, renewed or refunded; or

(iii) any funded debt incurred by the Corporation or any subsidiary in part payment of the cost of the acquisition of any additional property acquired after May 22, 1946, which, if secured, shall be secured by mortgage or lien only on such additional property, or any funded debt secured by mortgage or other lien existing at the time of acquisition on additional property acquired after said date if such mortgage or lien is

such that it does not become a lien on any other property of the Corporation or any subsidiary; but only in every such case if (x) the aggregate amount of the funded debt so incurred or so secured by mortgage or lien on any additional property in any particular instance shall not at the time of acquisition of such property by the Corporation or such subsidiary exceed 60% of the cost (which shall be deemed to include the amount of all indebtedness secured by liens, including existing liens on such property) of such property to the Corporation or such subsidiary, or 60% of the fair market value thereof (disregarding all indebtedness secured by liens on such property), whichever shall be less, at the time of the acquisition thereof by the Corporation or such subsidiary, and the determination by the Board of Directors of the Corporation of such fair market value shall, in the absence of fraud, be conclusive, and (y) the aggregate of the funded debt at the time outstanding and incurred in connection with the acquisition of, or secured by mortgage or lien existing on, all such additional property shall not exceed $1,200,000 in aggregate principal amount.

9. So long as any shares of Preferred Stock are outstanding, the consent of the holders of at least 50% of the shares of Preferred Stock at the time outstanding, given in person or by proxy either in writing or at a meeting called for that purpose, shall be necessary to effectuate or validate the action of the Corporation in doing, or in authorizing or permitting any subsidiary to do, as the case may be, any one or more of the following:

(a) the sale, lease, conveyance or other voluntary parting with control by the Corporation of all or substantially all of its assets, unless prior thereto all Preferred Stock has been or, simultaneously with the consummation of such transaction, is to be retired;

(b) the merger or consolidation of the Corporation into or with any other corporation or the merger of any other corporation into the Corporation unless the corporation resulting from such merger or consolidation will have, after such merger or consolidation, no class of stock and no other securities either authorized or outstanding ranking prior to or on a parity with

the Preferred Stock or convertible into or evidencing the right to purchase stock of any class ranking on a parity with or prior to the Preferred Stock, except the same number of shares of stock and the same amount of other securities with the same rights and preferences as the stock and securities of the Corporation, respectively, authorized and outstanding immediately preceding such merger or consolidation, and unless each person holding Preferred Stock immediately preceding such merger or consolidation shall, upon such merger or consolidation, receive the same number of shares with the same rights and preferences of the resulting corporation;

(c) the sale or other disposition, directly or indirectly (except to the Corporation), of shares of a subsidiary whereby such subsidiary shall cease to be a subsidiary of the Corporation; provided, however, that this provision shall not apply if by such sale or other disposition all shares of every class of such subsidiary owned by the Corporation or by any other subsidiary and all indebtedness of such subsidiary owing to the Corporation or any other subsidiary shall be disposed of;

(d) the merger or consolidation of any subsidiary into or with any other corporation or the merger of any other corporation into a subsidiary, unless in any of such cases such other corporation be the Corporation and such merger or consolidation may be made under paragraph (b) above without a vote of the holders of the Preferred Stock voting as a class;

(e) the creation, authorization or issue by any subsidiary of any stock ranking prior to the common stock of such subsidiary or of any stock or other security convertible into or exchangeable for shares of stock of any class ranking prior to such common stock; provided, however, that this provision shall not prevent the creation by any subsidiary of any such prior stock or convertible stock or other security for issuance, and the issuance or sale thereof, to the Corporation; but in any such event the Corporation shall not, without like vote, sell or dispose of such prior stock or convertible stock or other security unless prior thereto or simultaneously therewith all other stock of such subsidiary owned by the Corporation or any other subsidiary and all indebtedness of such subsidiary owing to the Corporation or

any other subsidiary is sold or disposed of; or

(f) purchase, redeem or otherwise acquire for a valuable consideration any shares of the Preferred Stock at a time when dividends on the Preferred Stock for all past dividend payment dates shall not have been fully paid, or declared and a sum sufficient for the payment thereof set apart; provided, however, that the Corporation may, nevertheless, without such consent of the holders of the Preferred Stock, purchase shares of Preferred Stock at any such time if it shall have (i) given the holders of all of the Preferred Stock then outstanding notice in writing addressed to them at their respective addresses appearing on the books of the Corporation of its desire to purchase shares of Preferred Stock and the amount of cash available for such purchase, and in such notice shall have requested tenders of Preferred Stock for sale to the Corporation on a date specified in such notice, which shall be at least 30 days after the date of mailing such notice, and (ii) purchased such shares pursuant to such tenders at prices not exceeding the price applicable for the redemption of Preferred Stock on such date pursuant to subdivision 3 hereof, unless the cash to be applied to such purchase constitutes sinking fund moneys, then at prices not exceeding the price then applicable for the redemption of Preferred Stock pursuant to subdivision 4 hereof, and (iii) purchased such shares in the order of the prices at which the same were offered to the Corporation pursuant to such request for tenders as aforesaid, commencing with the shares tendered at the lowest price, except that, if several acceptable tenders at the same price shall have been received, the Corporation may make a ratable acceptance thereof or may select one or more of said tenders for acceptance in whole or in part as it shall elect. This provision permitting the Corporation to purchase shares of Preferred Stock as aforesaid shall not be deemed to require it to accept any or all of the shares tendered as aforesaid, but merely to require that any shares of Preferred Stock purchased on the existence of a default in the payment of dividends on the Preferred Stock as aforesaid shall be purchased only upon consent or through tenders as above provided. The provisions of this paragraph shall not in any way restrict the right

of any holder of Preferred Stock to surrender, or the Corporation to receive, shares of Preferred Stock in exchange for shares of Common Stock upon the exercise of warrants pursuant to subdivision 11 hereof.

10. If at any time dividends upon the Preferred Stock shall be in arrears and such arrears shall aggregate an amount at least equal to 6 quarterly dividend payments, which need not be consecutive, then and in every such case, until all arrears in payment of the quarterly dividends on the Preferred Stock shall have been paid and the dividends thereon for the current quarter shall have been declared and funds for the payment thereof set aside, the holders of shares of Preferred Stock present in person or by proxy, voting as a class, shall be entitled at all elections of the Board of Directors by stockholders to elect such number of directors of the Corporation as shall constitute the largest number not more than one-third of the entire Board of Directors; and the holders of all other classes of stock entitled to vote in person or by proxy, voting as a class, shall be entitled to elect the remaining directors. Whenever by reason of the resignation, death or removal of any director or directors or any increase in the number of directors the number of directors in office who have been elected by the holders of stock voting as a class shall become less than the total number then subject to election by such class, the vacancy or vacancies so resulting may be filled by the affirmative vote of the director or directors at the time in office who were elected by the vote of such class, although less than a quorum.

Warrants for Acquisition of Common Stock

11. (a) Each holder of shares of Preferred Stock issued and outstanding on November 16, 1946, shall be entitled to receive a new certificate for such shares together with a warrant or warrants entitling such holder to obtain at any time on or prior to (but not after) December 1, 1950, upon the terms and conditions hereinafter and in said warrants provided, 2 shares of Common Stock of the Corporation, of the par value of $1 per share, for each such share of Preferred Stock of the Corporation held on November 16, 1946, such number of shares of Common Stock being subject to adjustment as hereinafter provided. Such warrants shall be in such form, specify such requirements for the exercise of the rights there-

under and contain such other provisions, not inconsistent with the provisions hereof, as may be determined by the Board of Directors of the Corporation. The holder of each such warrant may acquire all or part of the shares of Common Stock obtainable thereunder upon payment of the warrant price of $10 for each share of Common Stock acquired pursuant thereto in cash and/or by the surrender of a certificate or certificates for shares of Preferred Stock, so that the cash paid and the par value of the shares of Preferred Stock represented by the certificate or certificates so surrendered shall in the aggregate at least equal the aggregate warrant price for the share or shares of Common Stock to be so acquired, such warrant price being subject to adjustment as hereinafter provided. To the extent that shares of Preferred Stock are surrendered in payment of the warrant price and shares of Common Stock are issued on the basis of such surrender, the surrender and the issuance of such shares shall be deemed conclusively to be an exchange of stock of the Corporation, and upon any such exchange of stock, the capital of the Corporation shall remain unchanged. Any shares of Preferred Stock received upon any such exchange shall be cancelled and retired as provided in subdivision 5 hereof, and any cash received in payment of the warrant price upon the exercise of warrants shall be set aside as additional payments to the sinking fund as provided in subdivision 4 hereof. In the event that the holder of any warrant shall elect to exercise such warrant, in whole or in part, such warrant (accompanied by the certificate for the shares of Preferred Stock to which it shall appertain if such warrant is at the time non-detachable) shall be surrendered to the Corporation for such purpose at the office of any agent of the Corporation for the warrants (hereinafter sometimes called "warrant agent"), or if there be no such warrant agent, at the principal office of the Corporation, together with the cash and certificate or certificates for Preferred Stock, if any, at least equal to the warrant price as aforesaid; and the holder electing so to exercise such warrant shall comply with all of the terms and provisions of such warrant and regulations (not inconsistent with the provisions hereof) of the Corporation and such warrant agent. The Corporation shall thereupon issue and deliver a certificate or certificates for the number of shares of Common Stock in respect of which such

warrant shall have been exercised and such shares shall be fully paid and non-assessable. The Corporation will pay any and all original issue taxes required in connection with the issue of shares of Common Stock upon the exercise of any warrant.

(b) Prior to July 1, 1947, the warrants shall be non-detachable and may be exercised only by the holders of the shares of Preferred Stock represented by the certificates to which such warrants appertain, except that if any shares of Preferred Stock are called for redemption prior to July 1, 1947, the warrants issued in respect of such shares shall become detachable on the day preceding the date fixed for the redemption thereof, or at any time after the deposit of funds sufficient to provide for such redemption as provided in paragraph 3(c) hereof. On and after July 1, 1947, the warrants may, at the option of the holder thereof, be detached from the certificate for the shares of Preferred Stock to which they appertain. Any warrant which is detachable as aforesaid may be transferred separately and apart from a certificate for the shares of Preferred Stock. If there shall be surrendered to the Corporation or any transfer agent thereof a certificate for shares of Preferred Stock having attached thereto a warrant which is then non-detachable and a new certificate is required to be issued for any of the shares of Preferred Stock represented by such surrendered certificate, such new certificate shall have attached thereto a warrant entitling such holder to the same rights in respect of the acquisition of shares of Common Stock as remained unexercised on the warrant so surrendered; and if any warrant shall be exercised only in part, the holder thereof shall be entitled to receive a new warrant for the unexercised portion thereof. Upon the exercise of any warrant, in whole or in part, or upon the surrender to the Corporation or any transfer agent for the Preferred Stock of a certificate for Preferred Stock having attached thereto a warrant which shall then have expired, such exercised or expired warrant shall be detached and cancelled, and a new certificate for the shares of Preferred Stock evidenced by the certificate attached to such warrant (to the extent that such shares shall not have been exchanged for shares of Common Stock upon the exercise of such warrant) shall be executed and delivered to the registered holder thereof, but such new certificate shall not have attached thereto

any warrant, except to the extent that the warrant surrendered had not been exercised and had not expired.

(c) Certain terms used herein are hereby defined as follows:

(i) The term "basic warrant price" shall mean the warrant price per share stated on the face of the warrants.

(ii) The term "warrant price" shall mean the basic warrant price or the adjusted warrant price, adjusted as hereinafter provided, whichever may be in effect at the time.

(iii) The term "number of shares obtainable pursuant to any warrant" shall mean the number of shares of Common Stock of the Corporation stated on the face of such warrant as obtainable thereunder, or the adjusted number of such shares adjusted as hereinafter provided, whichever may be in effect at the time.

(iv) The term "basic shares" shall mean 643,000 shares, or such other number of shares as shall be the number of shares of Common Stock then outstanding as a result of changes into different numbers of shares of, or the payment of stock dividends on, the 643,000 shares of Common Stock, outstanding at the time of the first issuance of any warrants, or the shares resulting from such changes or dividends.

(v) The term "additional shares" shall mean all shares issued or deemed to be issued as hereinafter provided, other than the shares of Common Stock referred to in clause (iv) above and shares issued upon the exercise of any warrant.

(d) For the protection of the privilege of obtaining stock pursuant to this subdivision 11 and any warrant, the following rights, restrictions and obligations shall apply:

(i) In case the Corporation at any time during the life of the warrants shall issue any additional shares of Common Stock for a consideration per share less than the warrant price in effect immediately prior to the time of such issue, then forthwith upon such issue, such warrant price shall be reduced to a price which shall constitute the adjusted warrant price and shall be computed as follows: (x) the sum of the basic shares above mentioned and the number of any additional shares of Common Stock issued or deemed to have been issued at

a price or prices equal to or greater than the warrant price in effect immediately prior to the time of the issue thereof shall be multiplied by the warrant price in effect immediately prior to the time of the issue of additional Common Stock then being made, (y) the proceeds of the issue of the number of additional shares of Common Stock issued or deemed to have been issued at a price or prices less than the warrant price in effect immediately prior to the time of the issue thereof for which no adjustment of the warrant price has theretofore been effected shall be ascertained, (z) the sum of the product arrived at as provided in the foregoing clause (x) and the proceeds of the issue of Common Stock ascertained as provided in the foregoing clause (y) shall be divided by the total number of basic and additional shares of Common Stock referred to in said clauses (x) and (y), and the quotient calculated to the nearest cent shall be the adjusted warrant price and such adjusted warrant price shall be the price per share of Common Stock to be paid, in cash or by the exchange of Preferred Stock as aforesaid, upon the exercise of any warrant until a subsequent adjustment thereof. In no event shall the warrant price be increased by any such redetermination. The number of shares of Common Stock issued and outstanding at any time shall include all shares of such stock issuable in respect of scrip certificates, if any, outstanding, representing fractional interests in respect of the Common Stock of the Corporation.

(ii) The number of shares of Common Stock obtainable pursuant to any warrant after any adjustment of the warrant price pursuant to clause (i) of this paragraph (d) shall be determined by multiplying the number of shares obtainable pursuant to such warrant immediately prior to such adjustment by the warrant price in effect immediately prior to such adjustment, and dividing the product by the warrant price in effect immediately after such adjustment.

(iii) In case the Corporation during the life of the warrants shall issue or sell any securities convertible into additional shares of Common Stock of the Corporation at a conversion price per share (being the sum of the aggregate consideration received or receivable by the Corporation for such issue or sale and the

aggregate minimum consideration, if any, payable to the Corporation upon conversion divided by the aggregate number of shares of Common Stock into which said securities are then convertible) less than the warrant price in effect immediately prior to the issue or sale of such convertible securities, then for the purpose of determining the adjusted warrant price and the number of shares obtainable pursuant to any warrant, such issue or sale shall be deemed an issue or sale forthwith of the total maximum number of shares of Common Stock then necessary for the conversion of all such convertible securities at the conversion price per share; and the warrant price in effect immediately prior to such issue or sale and the number of shares obtainable pursuant to any warrant shall forthwith be adjusted in the manner provided by clauses (i) and (ii) of this paragraph (d); provided, however, that if the conversion rights with respect of any such securities expire for any reason without being exercised, then the adjusted warrant price and the number of shares obtainable pursuant to any warrant shall be readjusted as though such securities with respect of which the conversion rights had expired without being exercised, had not been issued or sold. No further adjustment of the warrant price or number of shares obtainable pursuant to any warrant shall be made upon the conversion of any such convertible securities or upon the issuance of shares of Common Stock pursuant thereto or upon the change in the conversion price.

(iv) In case the Corporation during the life of the warrants shall in any manner issue or sell any rights to subscribe for or options to purchase additional shares of Common Stock at a price per share (being the sum of the aggregate consideration received or receivable by the Corporation for the granting of such rights or options and the minimum amount of additional consideration payable to the Corporation upon the exercise of such rights or options divided by the aggregate number of shares of Common Stock purchasable on the exercise of such rights or options) less than the warrant price in effect immediately prior to the granting of such rights or options, then in any such case, for the purpose of computing the adjusted warrant price and

the number of shares obtainable pursuant to any warrant, such issue or sale shall be deemed to be an issue or sale forthwith of the total maximum number of additional shares of Common Stock issuable or deliverable on the exercise of all such rights or options, without any adjustments therein, at the price per share as above computed; and the warrant price in effect immediately prior to the offering, issue or sale of such rights or options and the number of shares obtainable pursuant to any warrant shall forthwith be adjusted in the manner provided in clauses (i) and (ii) of this paragraph (d); provided, however, that if any of such rights or options expire for any reason without having been exercised, then the adjusted warrant price and the number of shares obtainable pursuant to any warrant shall be readjusted as though such rights or options had not been issued or sold. No further adjustment of the warrant price or number of shares obtainable pursuant to any warrant shall be made upon the exercise of any such rights or options, upon the issuance of shares of Common Stock pursuant thereto or upon any change in the consideration payable to the Corporation upon the exercise of such rights or options.

(v) In case of the issuance for cash of additional shares of Common Stock or securities convertible into additional shares of Common Stock or of any rights to subscribe for or options to purchase additional shares of Common Stock or securities convertible into additional shares of Common Stock, the consideration received by the Corporation therefor shall be deemed to be the amount of cash received by the Corporation for such securities before deducting therefrom any commissions, discounts or expenses paid or incurred by the Corporation for any underwriting of the issuance and sale of such shares, convertible securities, rights or options, or otherwise, and any other expenses paid or incurred in connection with such issuance or sale.

(vi) In case of the issuance of additional shares of Common Stock or of securities convertible into additional shares of Common Stock or of any rights to subscribe for or options to purchase additional shares of Common Stock or securities convertible into additional shares of Common Stock for a consideration

other than cash, the consideration received by the Corporation therefor shall be deemed to be the fair value of such consideration as determined by the Board of Directors of the Corporation; provided, however, that if any such shares of Common Stock or such securities convertible into Common Stock or such rights or options be issued for any consideration other than cash and/or property of any kind (including tangible and intangible), the same shall be deemed to have been issued for cash for the price of zero dollars.

(vii) In case of any stock dividend or subdivision of the outstanding shares of Common Stock of the Corporation into a greater number of shares of Common Stock, the warrant price then in effect shall be proportionately reduced and the number of shares then obtainable pursuant to any warrant shall be proportionately increased and conversely in case of any contraction of the number of outstanding shares of Common Stock of the Corporation by combining such shares into a smaller number of shares, the warrant price then in effect shall be proportionately increased and the number of shares then obtainable pursuant to any warrant shall be proportionately decreased.

(viii) In case of the consolidation or merger of the Corporation with another entity or the reclassification of its Common Stock (other than by way of subdivision or contraction of outstanding shares of Common Stock), any warrant shall thereafter be exercisable to acquire the number of shares of stock or other securities or property of the Corporation or of the entity resulting from such consolidation or merger to which the number of shares then obtainable pursuant to such warrant would have been entitled upon such consolidation or merger or reclassification had the holder of such warrant exercised the rights thereunder to acquire shares of Common Stock, and such shares had been issued and outstanding and such holder had been the holder of record of such shares of Common Stock at the time thereof; and lawful provision therefor shall be made as a part of such consolidation, merger or reclassification.

(ix) In case the Corporation shall at any time make any distribution of its assets to the holders of its Common Stock as a dividend in partial liquidation or by way of return of capital or

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other than as a dividend payable on account of a complete liquidation or out of earnings or out of any surplus legally available for dividends under the laws of the State of Delaware, the holder of any warrant upon the exercise thereof at any time after the date of record of such distribution of assets shall be entitled to receive in addition to the number of shares then obtainable pursuant to such warrant and without the payment of any additional consideration therefor other than the warrant price of the shares, a sum equal to the fair value of such assets, or the pro rata portion of such assets, as would have been payable or distributable to such person as the owner of the number of shares of Common Stock of the Corporation obtainable pursuant to such warrant had such purchase privilege been exercised and such shares been issued and outstanding and had such person been the holder of record thereof on the record date for such distribution; and lawful provision therefor shall be made as a part of any such distribution.

(e) In case any additional shares of Common Stock are issued or deemed to have been issued so as to effect a redetermination or readjustment of the warrant price per share and the number of shares thereafter obtainable pursuant to any warrant, the Corporation shall immediately file with each warrant agent, notice in writing showing (i) the number of additional shares so issued or deemed to have been issued and the date of issuance, (ii) the price or prices at which such shares shall have been issued or shall have been deemed to have been issued, (iii) the warrant price per share of Common Stock thereafter obtainable upon the exercise of the warrants and the number of shares obtainable pursuant thereto; and (iv) in case such additional shares shall have been issued for a consideration other than cash, a true copy of the resolution of the Board of Directors of the Corporation determining the fair value of such consideration.

(f) In lieu of issuing fractional shares of its Common Stock upon the exercise of any warrant or warrants, the Corporation will make a cash settlement in respect thereof on the basis of a sum in cash equal to the product obtained by multiplying such fractional part by the market value of the Common Stock at the close of business on the day preceding the surrender of such warrant, such

market value to be determined in accordance with any regulations, reasonably established by the Board of Directors of the Corporation in respect thereof.

(g) So long as any warrant shall remain outstanding and unexpired, there shall be reserved such number of shares of Common Stock for issuance upon the exercise of the warrants as shall be required pursuant to the terms thereof. The Corporation shall from time to time, in accordance with the laws of the State of Delaware, increase the authorized amount of its Common Stock if at any time the number of shares of Common Stock remaining unissued shall not be sufficient to permit the exercise of all of the outstanding warrants hereunder.

(h) In case of any of the following events (i) the Corporation shall declare any dividend payable on its Common Stock in stock or otherwise than in cash, or make any distribution of its assets to the holders of its Common Stock as a dividend in partial liquidation or by way of return of capital or other than as a dividend payable in cash out of earnings or any surplus legally available for dividends under the laws of the State of Delaware, or (ii) the Corporation shall offer to the holders of its Common Stock any additional shares of stock of the Corporation or any rights to subscribe thereto, or (iii) any capital reorganization or reclassification of the Common Stock of the Corporation or its consolidation or merger with another entity other than a wholly owned subsidiary or the sale of all or substantially all of its assets shall be proposed, or (iv) a dissolution, liquidation or winding up of the Corporation shall be proposed by the Corporation, then in any one or more of said events, the Corporation shall cause notice thereof to be filed with each warrant agent and to be published once a week for 2 successive weeks, beginning on any day of the week, in 2 daily newspapers, printed in the English language and one of which shall be of general circulation in The City of New York, State of New York, and the other of which shall be of general circulation in the City of Denver, State of Colorado, such notice to be filed and the first publication thereof in each such newspaper to be made not less than 15 days prior to the date on which the books of the Corporation shall close or a record date be taken for such dividend, distribution or subscription rights or for voting with respect to such reclassification,

reorganization or merger, consolidation, sale, dissolution, liquidation or winding up. Such notice shall also specify the date as of which the books will close or a record of holders of the Common Stock shall be taken with respect thereto and shall state that the warrant price then in effect under the warrants as adjusted and the number of shares obtainable pursuant thereto may be obtained from any warrant agent and from the Corporation.

COMMON STOCK

Dividends

12. Subject to the provisions hereof in respect of shares of any class of stock of the Corporation ranking prior to the Common Stock, such dividends or distributions as may be determined by the Board of Directors may, from time to time, be declared and paid out of funds legally available therefor, or made upon, or in respect of, the Common Stock; and the shares of such class of prior stock shall not be entitled to participate therein.

Liquidation

13. Subject to the provisions hereof in respect of any class of stock of the Corporation ranking prior to the Common Stock, the holders of the Common Stock shall, upon any liquidation, dissolution or winding up of the affairs of the Corporation, be entitled as a class to receive, pro rata, the assets of the Corporation available for distribution after provision for the rights of all such prior stock.

Voting

14. The holders of the Common Stock shall have voting rights only as provided hereinafter in subdivision 15 hereof.

MISCELLANEOUS

15. Except as otherwise required by law and as otherwise provided above in subdivisions 8, 9 and 10 hereof in respect of the Preferred Stock, every share of stock of the Corporation, regardless of class, shall have equal voting rights, and each holder of stock of the Corporation entitled to vote shall have one vote for each share thereof held and entitled to vote.

16. No holder of shares of stock of any class of the Corporation shall be entitled, as such, to subscribe to or purchase any

additional shares of stock of any class (except as provided above in subdivision 11 hereof), whether now or hereafter authorized, or obligations convertible into any class or classes of stock, or shares of stock of any class convertible into stock of any other class or classes, or obligations, shares of stock or other securities carrying warrants or rights to subscribe to shares of stock of the Corporation of any class or classes, in any case whether now or hereafter authorized; but any and all shares of stock, bonds, debentures or other securities or obligations, whether or not convertible into stock or carrying warrants or rights entitling the holders thereof to subscribe to stock, may be issued, sold or disposed of from time to time by the Board of Directors to such persons, firms or corporations and for such consideration, so far as may be permitted by law, as it shall from time to time in its absolute discretion determine, without offering the same to the holders of shares of stock of the Corporation or any class then outstanding.

17. (a) The term "subsidiary" shall mean a corporation, association or business trust, of which at least a majority of the outstanding shares having by the terms thereof ordinary voting power to elect a majority of the board of directors of such corporation, association, or business trust (irrespective of whether or not at the time shares of any other class or classes shall have or might have voting power by reason of the happening of any contingency) is at the time, directly or indirectly, owned by the Corporation or by one or more other corporations or associations or business trusts whose shares are similarly owned.

(b) The term "funded debt" shall mean any indebtedness maturing by its terms more than 12 months from the date of the original creation thereof, or indebtedness extendable or renewable at the option of the obligor to a date more than 12 months from the date of the original creation thereof, and shall include all such indebtedness issued, assumed or guaranteed by the Corporation or any subsidiary."

FIFTH: The names and places of residence of each of the incorporators are as follows:

Name	Residence
Charles A. Davey	853 Carroll Street, Brooklyn, N. Y.
Pierce C. Pierson	37 West 72nd Street, New York, N. Y.
Sidney L. Smith	41-15 44th Street, Sunnyside, L. I., N. Y.

SIXTH: The Corporation is to have perpetual existence.

SEVENTH: The private property of the stockholders of the Corporation shall not be subject to the payment of corporate debts to any extent whatsoever.

EIGHTH: The following provisions are hereby inserted for the management of the business and for the conduct of the affairs of the Corporation and for creating, defining, limiting and regulating the powers of the Corporation, the directors and the stockholders, said provisions being in furtherance of and in addition to, and not in limitation of, the powers now or hereafter conferred by the present or any future law or laws of the State of Delaware.

1. The Corporation is expressly authorized and empowered:

(a) To acquire, hold, use, deal in and dispose of, and to exercise all of the rights, powers and privileges of a natural person with respect to, any and all real and personal property, tangible and intangible, and interests therein, of every nature whatsoever, and wheresoever located.

(b) To conduct any or all of its business as principal, agent, factor, contractor, or otherwise, directly or indirectly, and individually or jointly with others.

(c) To confer upon the holders of any of the securities of whatsoever nature issued by it the right to convert the same into stock of the Corporation of any class or classes.

(d) To borrow money, from any and all sources, for any of the purposes of the Corporation, and to acquire, hold, sell or otherwise deal in securities of any and all kinds and descriptions, whether issued by itself or by any other issuer, and to take such action from time to time and upon such terms as its Board of

Directors shall determine; subject, always, to the laws of the State of Delaware with respect thereto.

(c) To do all things necessary or appropriate for the accomplishment of any of the businesses, objects or purposes of the Corporation, or designed to promote the interests of the Corporation directly or indirectly; and in general to do any and all things and exercise any and all powers now or hereafter conferred upon corporations of the general character of this Corporation by the laws of the State of Delaware.

2. The number of directors of the Corporation shall be fixed by its by-laws and may be altered from time to time by amending the by-laws as therein provided, but the number thereof shall never be less than 5. A director need not be a stockholder. The election of directors need not be by ballot unless the by-laws so require. In case of any increase in the number of directors, the additional directorships so created may be filled in the first instance in the same manner as a vacancy in the Board of Directors.

3. The Board of Directors of the Corporation shall have power, among other things:

(a) To make, amend and repeal the by-laws of the Corporation, subject to the power of the holders of the capital stock entitled to vote thereon to alter, amend or repeal the by-laws made by the Board of Directors.

(b) From time to time to determine whether and to what extent and at what times and places and under what conditions and regulations, the accounts and books of the Corporation (other than the stock ledger), or any of them, shall be open to the inspection of the stockholders; and no stockholder shall have any right, except as conferred by statute, to inspect any account, book or document of the Corporation, unless expressly so authorized by resolution of the Board of Directors or the stockholders.

(c) Except as otherwise may be expressly provided in the Certificate of Incorporation, to authorize and issue obligations of the Corporation, secured or unsecured, without the assent or vote of the stockholders, and to include therein such provisions as to redeemability, convertibility or otherwise as the Board of Directors, in its sole discretion may determine, and to authorize

the mortaging or pledging, as security therefor, of any property of the Corporation, real or personal, including after-acquired property.

(d) From time to time to fix and determine and to vary the amount of the working capital of the Corporation; to direct and determine whether any, and if any, what part, of the surplus or net profits of the Corporation shall be declared in dividends and paid to the stockholders; and to set apart any of the funds of the Corporation otherwise available for dividends as a reserve or reserves for any proper purpose and to abolish any such reserve in the manner in which it was created.

In addition to the powers hereinbefore or by statute expressly conferred upon it, the Board of Directors may exercise all such powers and do all such acts and things as may be exercised or done by the Corporation, subject, nevertheless, to the provisions of the laws of the State of Delaware, of the Certificate of Incorporation and of the by-laws of the Corporation.

4. Both the Board of Directors and the stockholders of the Corporation shall have power to hold their meetings and to have one or more offices within or without the State of Delaware, as may from time to time be designated by the Board of Directors or the by-laws of the Corporation.

5. A Director of the Corporation shall not, in the absence of fraud, be disqualified by his office from dealing or contracting with the Corporation either as vendor, purchaser or otherwise; nor, in the absence of fraud, shall any transaction or contract of the Corporation be void or voidable by reason of the fact that any director or any firm of which any director is a member or any corporation of which any director is a stockholder, director or officer is in any way interested in such transaction or contract, provided such transaction or contract is or shall be authorized, ratified or approved, with notice or knowledge of the fact of such interest, either (a) by a vote of a majority of a quorum of the Board of Directors, or of the Executive Committee, if any, without counting in such majority (although counting in any such quorum) any director so interested or who is a member of a firm so interested or a stockholder, director or officer of a corporation so interested, or (b) by vote at a stockholders meeting of the holders of record of a majority of all the out-

standing shares of stock of the Corporation then entitled to vote or by writing or writings signed by a majority of such holders; nor shall any director be liable to account to the Corporation for any profits realized by him from or through any such transaction or contract with the Corporation authorized, ratified or approved as aforesaid by reason of the fact that he or any firm of which he is a member or any corporation of which he is a stockholder, director or officer, was interested in such transactions or contract. Nothing in this section shall create any liability in the above mentioned events or prevent the authorization, ratification or approval of such transactions or contracts in any other manner permitted by law; nor shall anything in this paragraph apply to transactions in the ordinary course of business.

NINTH: Any and all directors and officers and former directors and officers of the Corporation, and any person who may have served at the request of the Corporation as director or officer of another corporation in which the Corporation owns or owned shares of capital stock or of which it is or was a creditor, hereby are, and each hereby is, automatically and without any further action by the Corporation indemnified by the Corporation against any and all expenses actually and necessarily incurred by them in connection with the defense of any action, suit or proceedings in which they, or any of them, are made parties or a party by reason of being or having been directors or officers, or a director or officer, of the Corporation or such other corporation, except in relation to matters as to which any such director or officer or former director or officer or person shall be finally adjudged in such action, suit or proceeding to be liable for negligence or misconduct in the performance of duties as such officer or director, and also against liability for any amount paid and expenses incurred in connection with reasonable settlements (other than amounts paid to the Corporation itself) made solely with a view to curtailment of costs of litigation.

Such indemnification shall not be exclusive of, nor preclude, any such director or officer from exercising any other rights to which such director or officer may be entitled as a matter of law.

TENTH: Whenever a compromise or arrangement is proposed between this Corporation and its creditors or any class of them and/or between this Corporation and its stockholders or any class of them, any court of equitable jurisdiction within the State of Delaware may, on the

application in a summary way of this Corporation or of any creditor or stockholder thereof, or on the application of any receiver or receivers appointed for this Corporation under the provisions of Section 41 of Chapter 117 of the Revised Code of Delaware, 1935, or on the application of trustees in dissolution or of any receiver or receivers appointed for this Corporation under the provisions of Section 43 of said Chapter, order a meeting of the creditors or class of creditors, and/or of the stockholders or class of stockholders of this Corporation, as the case may be, to be summoned in such manner as the said Court directs. If a majority in number representing three-fourths in value of the creditors or class of creditors, and/or of the stockholders or class of stockholders of this Corporation, as the case may be, agree to any compromise or arrangement and to any reorganization of this Corporation as consequence of such compromise or arrangement, the said compromise or arrangement and the said reorganization shall, if sanctioned by the Court to which the said application has been made, be binding on all the creditors or class of creditors, and or on all the stockholders or class of stockholders, of this Corporation, as the case may be, and also on this Corporation.

ELEVENTH: The Corporation reserves the right to amend, alter, change or repeal any provision contained in its Certificate of Incorporation, in the manner now or hereafter prescribed by Statute, and all the rights conferred upon stockholders and directors herein are granted subject to this reservation.

WE, THE UNDERSIGNED, being each of the incorporators hereinbefore named, for the purpose of forming a corporation to do business both within and without the State of Delaware, and in pursuance of the General Corporation Law of the State of Delaware and the acts amendatory thereof and supplemental thereto, do make and file this Certificate, hereby declaring and certifying that the facts herein stated are true, and accordingly have hereunto set our hands and seals this 3d day of May, 1946.

JAMES A. DAVEY (L.S.)
PIERCE C. PIERSON (L.S.)
SIDNEY L. SMITH (L.S.)

In the Presence of:
MAE J. CANNON

STATE OF NEW YORK, }
COUNTY OF NEW YORK, } ss.:

BE IT REMEMBERED that on this 3rd day of May, A. D. 1946, personally came before me Mae J. Cannon, a notary public in and for the County and State aforesaid, Charles A. Davey, Pierce C. Pierson and Sidney L. Smith, parties to the foregoing Certificate of Incorporation, known to me personally to be such, and severally acknowledged the said certificate to be the act and deed of the signers, respectively, and that the facts therein stated are truly set forth.

GIVEN under my hand and seal of office the day and year aforesaid.

MAE J. CANNON
Notary Public.

MAE J. CANNON
Notary Public
Kings County
Certificate filed in
New York County

MAE J. CANNON
Notary Public, State of New York
Residing in Kings County
Kings Co. Clerk's No. 45 Register's No. 31-C-8
New York Co. Clerk's No. 240, Reg. No. 25-C-8
Commission Expires March 30, 1948

MAE J. CANNON
NOTARY PUBLIC
STATE OF NEW YORK

Notation Re Opinion of Tax Court

The opinion of the Tax Court is printed in the Petition for Certiorari, and may be found therein at pages 18–41, as Appendix A. It is therefore not reprinted in this Appendix.

DECISION

(Filed October 18, 1971)

UNITED STATES TAX COURT
WASHINGTON

[CAPTION OMITTED]

DECISION

Pursuant to the determination of the Court as set forth in its Opinion, dated October 14, 1971, it is

ORDERED and DECIDED: That there is a deficiency in income tax due from the petitioner for the taxable year ended April 30, 1967 in the amount of $147,949.76.

Entered: October 18, 1971.

/s/ Irene F. Scott
Judge.

NOTICE OF APPEAL

(Filed January 3, 1972)

UNITED STATES TAX COURT

[CAPTION OMITTED]

NOTICE OF APPEAL

Notice is hereby given that Petitioner, National Alfalfa Dehydrating and Milling Company, hereby appeals to the United States Court of Appeals for the Tenth Circuit from the decision of this court entered in the above captioned proceeding on the 18th day of October, 1971.

/s/ Charles White Hess
Charles White Hess
/s/ Ronald B. Stang
Ronald B. Stang
Linde, Thomson, Van Dyke, Fairchild and Langworthy
Floor Three, Columbia Union Bank Bldg.
Kansas City, Missouri 64106
816-474-6420
Counsel for Petitioner National Alfalfa Dehydrating and Milling Company

Notation Re Opinion and Judgment of the Court of Appeals

The opinion of the court of appeals is printed in the Petition for Certiorari, and may be found therein at pages 42–69, as Appendix B. The judgment of the court of appeals is printed in the Petition for Certiorari, and may be found therein at pages 70–71, as Appendix C. They are therefore not reprinted in this Appendix.

Supreme Court of the United States

No. 73-9

Commissioner of Internal Revenue,

Petitioner,

v.

National Alfalfa Dehydrating and Milling Company

ORDER ALLOWING CERTIORARI. Filed October 9 ---------- , 1973

The petition herein for a writ of certiorari to the United States Court of Appeals for the Tenth ---------- Circuit is granted.

U.S. GOVERNMENT PRINTING OFFICE : 1973—O-524-785

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In the Supreme Court of the United States

OCTOBER TERM, 1972

No.

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

The Solicitor General, on behalf of the Commissioner of Internal Revenue, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Tenth Circuit in this case.

OPINIONS BELOW

The opinion of the Tax Court (Appendix A, *infra*, pp. 18-41) is reported at 57 T.C. 46. The opinion of the court of appeals (Appendix B, *infra*, pp. 42-69) is reported at 472 F. 2d 796.

JURISDICTION

The judgment of the court of appeals (Appendix C, *infra*, pp. 70-71) was entered on January 26, 1973. By order dated April 18, 1973, Mr. Justice White extended the time for filing a petition for a writ of certiorari to and including June 25, 1973. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether, upon the amendment of respondent's certificate of incorporation to eliminate its outstanding 47,059 shares of $50 par 5% cumulative preferred stock and the issuance of a 5% debenture in the face amount of $50 in lieu of each share of the eliminated preferred stock, respondent became entitled to deductions for amortizable bond discount.

STATUTE AND REGULATIONS INVOLVED

The pertinent provisions of Sections 163 and 1232 of the Internal Revenue Code of 1954, and of Treasury Regulations on Income Tax (1954 Code) §§ 1.61-12 (as effective in 1957) and 1.163-3 (effective since 1968) are set forth in Appendix D, *infra*, pp. 72-76.

STATEMENT

Respondent is a Delaware corporation engaged in business in Shawnee Mission, Kansas. In July, 1957, in addition to an issue of $1 par common stock, respondent had outstanding an issue of 47,059 shares

of $50 par, 5% cumulative preferred stock, on which there were then dividend arrearages of $10. These preferred shares were redeemable in whole or in part at the discretion of respondent's board of directors, or through the operation of a sinking fund, at a price which was, in 1957, $51 per share plus accrued dividends. When, however, there were dividend arrearages on the cumulative preferred shares, there were restrictions upon acquisition and retirement in transactions with individual shareholders. Upon voluntary liquidation of the corporation, holders of the preferred shares were entitled to $50 per share, plus accrued dividends, prior to any distribution to common shareholders. (Appendix B, *infra*, pp. 43-44.)

As a result of action by respondent's board of directors in April, 1957, and a two-thirds vote by both classes of its shareholders in July, 1957, respondent's certificate of incorporation was amended, effective August 1, 1957, to eliminate the cumulative preferred shares and to increase the par value of the common shares from $1 to $3. By the same action, an issue of 5% debentures due July 1, 1975, was authorized in the aggregate amount of $2,352,950, and it was provided that a 5% debenture in the face amount of $50 was to be issued for each share of the eliminated $50 par, 5% cumulative preferred stock. A warrant to purchase one-half share of common stock at $10 per share was also issued for each share of the eliminated preferred in lieu of the dividend arrearages. There were sinking fund provisions with respect to the debentures comparable to, but not identical with,

the previous sinking fund for the preferred shares. After this transaction took place, it was reflected on respondent's books by debiting preferred stock for the $2,352,950 eliminated, and crediting the liability account for the newly issued debenture in the same amount of $2,352,950. (Appendix A, *infra*, p. 23; Appendix B, *infra*, pp. 44-48, 49-50.) Bid and asked prices for respondent's preferred shares ranged around $33 per share in July, 1957.

On its income tax returns for fiscal years ended April 30, 1958 through 1967, respondent claimed deductions for bond discount asserted to have been created upon the issuance of its $50 debentures, and to have been measured by the difference between the asserted market value of $33 for each share of the eliminated preferred stock and the $50 face amount of each debenture issued in lieu of a share of preferred stock. The deductions in earlier years were included in losses carried over to fiscal 1967. The Commissioner of Internal Revenue disallowed a deduction of $109,804 for bond discount for 1967, and $321,657 of claimed loss carryovers from prior years by virtue of deductions for bond discount claimed in those years, and a deficiency was asserted for 1967. (Appendix B, *infra*, p. 51.)

Upon respondent's petition to the Tax Court, that court, in a unanimous reviewed decision, upheld the deficiency asserted by the Commissioner, following recent decisions in the Court of Claims which had held that when a corporation issues its obligations

for or in lieu of its own previously outstanding preferred stock or bonds, no discount could arise from the issuance of those obligations if the amount received upon the issuance of the original securities was equal to the face amount of the obligations issued in exchange, and that the market value of the original securities at the time of the exchange was irrelevant. (Appendix A, *infra*, pp. 27-34.)

On respondent's appeal to the Court of Appeals for the Tenth Circuit, that court (2-1) reversed, refusing to follow the decisions of the Court of Claims because, as it stated, those decisions were based upon the unsound premise that a deduction for bond discount depended upon the taxpayer claiming such a deduction having suffered a loss in the transaction. (Appendix B, *infra*, pp. 54, 58, 64-65.) The court also assimilated the transaction here in question to the issuance of debentures for cash at a discount, followed by the use of the cash thus procured to retire outstanding preferred stock. (Appendix B, *infra*, pp. 53-54.) It further assimilated the transaction to a bonds-for-property transaction with regard to which there was a preexisting conflict of decisions. (Appendix B, *infra*, pp. 59-64.) The dissenting judge agreed with the majority that bond discount serves the same function as interest, but found that this did not provide any basis for disagreeing with the decisions of the Court of Claims; he rejected as inapplicable the analogies invoked by the majority.

REASONS FOR GRANTING THE WRIT

1. The decision of the Tenth Circuit is in direct and acknowledged conflict with the decisions of the Court of Claims in *Erie Lackawanna Railroad Co.* v. *United States*, 422 F. 2d 425, *Missouri Pacific Railroad Co.* v. *United States*, 427 F. 2d 727, modified, 433 F. 2d 1324, certiorari denied, 402 U.S. 944, and *St. Louis-San Francisco Railway Co.* v. *United States*, 444 F. 2d 1102, certiorari denied, 404 U.S. 1017.[1] It is also in conflict, though unacknowledged, with the decision of the Fifth Circuit in *Claussen's, Inc.* v. *United States*, 469 F. 2d 340. It is inconsistent, also, with the position of the Internal Revenue Service as set forth in Rev. Rul. 59-387, 1959-2 Cum. Bull. 56.

2. The question presented in this case is whether the respondent incurred bond discount—a cost of borrowing over and above stated interest—when it issued a 5% debenture in the face amount of $50 in substitution for a previously outstanding share of $50 par, 5% cumulative preferred stock. The Tax Court, following the decisions of the Court of Claims, held that discount could not arise in such a transaction when the face amount of the debentures was no

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[1] These decisions of the Court of Claims have been followed in all respects here relevant in several district court decisions still open for appeal: *Cities Service Co.* v. *United States*, 316 F. Supp. 61 (S.D. N.Y.), reaffirmed, 330 F. Supp. 421; *Gulf, Mobile & Ohio Railroad Co.* v. *United States*, 339 F. Supp. 489 (S.D. Ala.); *Texstar Corp.* v. *United States*, 73-1 U.S. T.C., par. 9105 (N.D. Tex.).

greater than the amount received by the corporation upon issuance of the preferred stock for which the debentures were substituted. The court of appeals, looking to the market value of the preferred stock at the time of the transaction, reversed the decision of the Tax Court, and held that discount, measured by the difference between the market value of the preferred stock and the face amount of the debentures issued in substitution, arose from the transaction.

The prototype transaction in which bond discount arises is one in which a corporation receives, for example, $950 upon the issuance of its bond in the face amount of $1,000, payable ten years after issuance. In such a case, the $50 difference between the amount received, or issue price, and the face amount of the bond is discount, deductible at the rate of $5 per year over the ten-year life of the bond.[2] Though the Internal Revenue Code and its predecessor Revenue Acts have never explicitly provided for the amortization and deduction of bond discount, Article 150 of Treasury Regulations 33 (1918 ed.) authorized such amortization and deduction, and all subsequent Treasury Regulations under the income tax statutes have done the same.[3] Under the 1954 Code, the provision first appeared as § 1.61-12(c)(3), Appendix D, *infra*, pp. 74-75. Since 1968, it has appeared, somewhat

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[2] Cf. Treasury Regulations on Income Tax (1954 Code), § 1.163-3(b)(1), Appendix D, *infra*, p. 76.

[3] The history of these Regulations is set forth in *Montana Power Co.* v. *United States*, 232 F. 2d 541, 546-548 (C.A. 3), certiorari denied, 352 U.S. 843.

more appropriately, as § 1.163-3(a) and (b), Appendix D, *infra*, pp. 75-76.[4]

Despite the remarks of the court of appeals, there is no issue in this case—unless it be a purely abstract and verbal issue of classification or usage[5]—concerning the nature of discount as "loss" or as "interest." The issue is whether the respondent incurred any added cost, over and above stated interest, for capi-

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[4] Section 61 sets forth the statutory definition of gross income. Section 163, Appendix D, *infra*, p. 72, authorizes a deduction for interest paid or accrued.

[5] It makes no practical difference in terms of a corporation's tax obligation whether discount be categorized as giving rise to loss or as giving rise to the payment of interest. As this Court pointed out in *Helvering* v. *Union Pacific Co.*, 293 U.S. 282, 284-285, the early Regulations spoke of discount in terms of loss sustained upon the payment of bonds at maturity, although they authorized amortization and deduction in anticipation of payment. The Court itself referred to discount both as "interest paid for the use of capital procured by a bond issue" and as "a loss resulting from the funding operation" (293 U.S., p. 286) within the same paragraph, and as "a loss to the taxpayer" and "part of the cost of the borrowed capital" within the same sentence (p. 287). More recently, the Court has been more explicit in referring to discount as interest. *United States* v. *Midland-Ross Corp.*, 381 U.S. 54, 57, 58, 66-67. As noted above, the current Regulations authorize the amortization and deduction of discount under Section 163, which allows the deduction of interest paid or accrued.

As a matter of fact, the Court of Claims, in both its *Erie Lackawanna* and its *Missouri Pacific* opinions, rather than basing its decisions upon the "unsound premise" of loss that the court below thought it perceived, expressly noted the variant references to discount as loss and as interest, stated the difference was irrelevant, and added that it would nonetheless treat discount as interest. See 422 F. 2d, pp. 427-428, fn. 7; 427 F. 2d, p. 730.

tal procured when it substituted its $50 debentures for the eliminated shares of $50 par preferred stock. *Helvering* v. *Union Pacific Co.*, 293 U.S. 282, 284-287; *Old Mission Co.* v. *Helvering*, 293 U.S. 289, 292-293; *United States* v. *Midland-Ross Corp.*, 381 U.S. 54. As a matter of simple arithmetic, a corporation that issues a share of preferred stock for $50, then substitutes its $50 debenture for the share of preferred stock, and ultimately discharges the debenture for its $50 face amount, has obviously incurred no cost, other than the dividends on the preferred stock and the stated interest on the debenture, for the $50 of capital that it has procured and employed. Whether one categorizes discount as "loss" or as "interest," there can be no discount when there is no outlay, and no obligation to make an outlay, greater than the amount received. *Old Mission Co.* v. *Helvering*, *supra*, p. 292.

The court below sought to avoid the obvious fact that respondent was not obligated to pay more in discharge of its debentures than it had received for its preferred stock by assimilating the transaction to a sale of the debentures for $33 in cash, followed by the use of that cash to purchase and retire the preferred stock.* Appendix B, *infra*, pp. 53-54. But such

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* The record, based upon wholly stipulated facts, does not establish or indicate at what price respondent's debentures might have been sold in an arms-length transaction in 1957. The record does establish that there were restrictions upon respondent's power to purchase its preferred stock in 1957,

a contrary-to-fact analysis has been specifically rejected by this Court in determining the existence and amount of discount when a corporation substitutes one issue of its securities for another. *Great Western Power Co.* v. *Commissioner*, 297 U.S. 543, 546-547. From the point of view of the corporation,[7] such a substitution constitutes a continuum, not two separate transactions. *Great Western Power Co.* v. *Commissioner, supra; Commissioner* v. *Capento Securities Corp.*, 140 F. 2d 382 (C.A. 1). Cf. *Chock Full O'Nuts Corp.* v. *United States*, 453 F. 2d 300

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while there were dividend arrearages. Appendix B, *infra*, pp. 44.

[7] The court below clearly misunderstood the Treasury's ruling with respect to the treatment of respondent's preferred shareholders whose preferred stock was eliminated, and who received debentures in substitution therefor. Appendix B, *infra*, pp. 48-49, 58. As Sections 354(a)(2) and 356(d) of the Internal Revenue Code provide and the ruling stated, shareholders who exchange shares of stock for corporate obligations in a recapitalization or other reorganization, will recognize gain or loss, if there is gain or loss. The amount of the gain or loss will be measured by the difference between the basis of the shares surrendered and the value of the obligations received. Sec. 1001(a). A shareholder who had bought a share of preferred stock for $50 and received a debenture worth $50 would therefore have zero gain, and not gain measured by the difference between $33 and $50, as the court below apparently understood. Appendix B, *infra*, p. 58. Such gain as might arise if the shareholder had a lower cost for his preferred stock than the value of the debentures received would presumably be capital gain. On the other hand, *if*, but only if, the transaction gave rise to amortizable discount to the corporation, as the court below held, *then* the recipient of the bond would be required by Section 1232(a) to report the amount of the discount as ordinary income. Cf. *United States* v. *Midland-Ross Corp.*, 381 U.S. 54.

(C.A. 2); *AMF, Inc.* v. *United States*, 73-1 U.S.T.C., par. 9353 (Ct. Cl.); *Hunt Foods and Industries, Inc.* v. *Commissioner*, 57 T.C. 633, on appeal to C.A. 9.

The court below also sought to assimilate the transaction in this case to the issue of bonds for property, and to its recent decision in *Atchison, Topeka and Santa Fe R. Co.* v. *United States*, 443 F. 2d 147, in which it had held that discount could arise on such a transaction. Appendix B, *infra*, pp. 59-64. There has been a long-standing conflict on this question.[8] On the one hand, it is held that, absent an explicit agreement otherwise, the face amount of bonds issued for property establishes the price paid for the property, so that no discount can have arisen. On the other, it is held that the market value of the property can be independently proven, and the difference between the market value of the property and the face amount of the bonds issued therefor will constitute discount. But when a corporation retires one issue of its securities and substitutes another issue therefor, it acquires no property. *United States* v.

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[8] The conflicting decisions with respect to bonds-for-property transactions are set forth and discussed in *Missouri Pacific Railroad Co.* v. *United States*, 427 F. 2d 727, 731-732, fn. 7 and 8 (Ct. Cl.).

The bonds with respect to which discount was claimed and allowed in the *Atchison, Topeka and Santa Fe* case were issued in a railroad reorganization in 1895, though the claimed deduction for discount involved the year 1950. Because the nature and terms of the reorganization were somewhat obscure, and because the decision turned at least in part (443 F. 2d, p. 152) upon the fact that the reorganization was a pre-1913 transaction, it did not appear appropriate to seek review by this Court.

Anderson, Clayton & Co., 350 U.S. 55. The point of departure for the conflict in the bonds-for-property cases is therefore absent in cases such as the present one, where one issue of securities is substituted for another. To assert that the *Atchison, Topeka and Santa Fe* decision was either controlling or of guiding relevance in this case was either, at best, to beg the question in this case, or, as we believe, to invoke a decision of little or no relevance.

3. Though we believe it clear and obvious that no discount can arise where a share of preferred stock is issued for $50, where the preferred stock is thereafter cancelled, and an obligation for $50 is issued in its stead, and though this case can be disposed of on that basis, the Fifth Circuit's decision of the immediately related issue in *Claussen's, Inc.* v. *United States*, 469 F. 2d 340, gives added support to our conclusion.

While the Court of Claims and the district court decisions referred to in footnote 1, *supra*, have agreed that the amount received for the original securities constitutes a floor below which no claim for discount can be allowed upon the issuance of corporate obligations in substitution for the original securities, they have drawn a negative inference to the effect that discount may arise if the face amount of the obligations issued in substitution is greater than the amount originally received for the first securities, and have stated that in such circumstances discount will be measured by the difference between the value to the corporation of the securities eliminated

and the face amount of the obligations issued in substitution. This was originally set forth in *Cities Service Co.* v. *United States*, 316 F. Supp. 61 (S.D. N.Y.), and accepted by the Court of Claims in its *Missouri Pacific* and *St. Louis-San Francisco* decisions, *supra*.

The Fifth Circuit's *Claussen's* decision has rejected, correctly, we believe, the idea that discount may arise from the substitution of one issue of securities for another, where there is no new borrowing—no procurement of new capital. In that case the taxpayer-corporation issued 6% debentures in the aggregate face amount of $2,250,000, plus new common stock and stock purchase warrants, for previously outstanding common stock. An aggregate of $1,962,-500 had been received by the corporation upon issuance of the original common stock, and that amount thereafter constituted the capital and paid-in surplus of the corporation. That amount was also found to be the value of the outstanding common stock at the time of the exchange. The court of appeals denied the claim that the $362,500 difference constituted bond discount, pointing out that the corporation had acquired no new capital and that the shareholders had surrendered nothing to the corporation for which there could be a cost of borrowing. It noted that in a slightly different context an issue of bonds and stock for previously outstanding stock had been held to give rise to a dividend. *Bazley* v. *Commissioner*, 331 U.S. 737. Cf. Sec. 356(a)(2) and (d), Internal Revenue Code of 1954.

It is clear that if a corporation retires a share of preferred stock issued at $100 for a call price of $105, or a share of common stock for a price greater than the issue price, the corporation does not obtain thereby a deduction from gross income. Sec. 311(a), Internal Revenue Code of 1954. If, instead of paying cash for the retirement of the stock, it issues its obligation for the same amount payable in the future, there is no reason why it should be permitted to deduct as discount what it could not deduct if it had paid cash, whatever may prove to have been the market value of the stock at the time of retirement. There may be many reasons (including, for example, a compulsory sinking fund) why a corporation may be led to pay more than could be established as market value in order to retire shares of stock. And the deferral of the payment is no indication of discount. Unless it can be established other than through evidence of market value that the corporation was paying for the privilege of deferral (as might possibly be the case where the deferred obligation was non-interest-bearing) there is no basis for discount.

As we have stated, there is not present in this case the factual basis for the negative inference accepted by the Court of Claims and the district courts where obligations are issued in face amount greater than was received for the original securities. But the Fifth Circuit's *Claussen's* decision demonstrates, even when that added element did exist, the irrelevance, or extremely limtied relevance, of the market value of

shares of stock for which corporate obligations are substituted.

4. The administrative importance of the question here involved is great, and in view of the conflict of decisions the question can be resolved only by this Court. Though Section 1232(b) of the Internal Revenue Code, Appendix D, *infra*, pp. 72-74, as amended by Section 413 of the Tax Reform Act of 1969, P.L. 91-172, 83 Stat. 487, may have disposed of this and related questions with respect to subsequent issues of corporate obligations, it is applicable only to bonds issued after May 27, 1969.

Meanwhile, as we are informed by the Internal Revenue Service, there are outstanding billions of dollars of long-term bonds that were issued in substitution or exchange for other securities in the course of railroad reorganizations alone. Claims for discount will be potential and recurrent during the many years that these bonds will remain outstanding. It may be recalled that the claim for discount in the *Atchison, Topeka and Santa Fe* case was first made for 1950, though the bonds had been issued in 1895. In addition, there have been similar bond issues presenting the same questions with relation to the reorganization of public utility holding companies. See, *e.g., Cities Service Co.* v. *United States supra.* There are also, in numbers difficult to estimate, outstanding bonds resulting from voluntary reorganizations or recapitalizations such as those involved in this case and in the *Claussen's* case. One of the factors leading to the 1969 legislation was the widespread

use of bonds in conglomerate acquisitions. Though these latter may involve more bonds-for-property transactions than substitutions for preexisting securities, the Internal Revenue Service anticipates a variety of bond discount problems arising from the surge of conglomerate acquisitions prior to 1969.

The amounts involved in bond discount issues are characteristically large, and will be recurrent far into the future, as is evident from the reported decisions alone. Gulf, Mobile & Ohio Railroad Company has claimed bond discount of nearly $5,200,000 on the issuance of 100-year debentures in the face amount of $12,653,000 in 1958 for preferred stock with an asserted market value of $7,465,000. Missouri Pacific Railroad Company claimed bond discount of $76,965,000 on its issuance in 1956 of 90-year debentures in the face amount of $529,117,000 for its bonds and its subsidiaries' bonds and stock. St. Louis-San Francisco Railway Company claimed bond discount of $29,068,000 on issuance of $120,935,000 of bonds in a 1947 reorganization, and additional discount of $10,220,000 on issuance of $33,129,000 of debentures in a recapitalization in 1956. Other claims for bond discount that have been presented to the Internal Revenue Service have involved, as we are informed, even larger amounts.

CONCLUSION

For the reasons stated, the petition for a writ of certiorari should be granted.

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JUNE 1973.

APPENDIX A

57 T. C. No. 6

UNITED STATES TAX COURT

Docket No. 1081-70

Filed October 14, 1971

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Petitioner, a corporation with its principal office at the time the petition in this case was filed in Shawnee Mission, Kansas, in July 1957, pursuant to a resolution providing for a reorganization and recapitalization, issued its debenture bonds of a face amount of $50 in exchange for its preferred stock of a par value of $50 and canceled the preferred stock received in the exchange. At the date of the exchange the preferred stock was quoted on the "over-the-counter" market at prices averaging around $33 per share. Petitioner, for its fiscal years ended April 30, 1958, through April 30, 1967, is not entitled to deductions for amortizable debt discount and therefore respondent correctly disallowed this claimed deduction for its fiscal year 1967 (here in issue) and for its prior fiscal years for computation of loss carryovers. *Atchison, Topeka and Santa Fe R. Co.* v. *United States*, 443 F. 2d 147 (C.A. 10, 1971), distinguished.

Charles W. Hess and *James J. Melching*, for the petitioner.

David A. Pierce, for the respondent.

OPINION

SCOTT, *Judge*: Respondent determined a deficiency in petitioner's income tax for the fiscal year ended April 30, 1967, in the amount of $147,949.76.

The issue for decision is whether petitioner is entitled to a deduction for amortizable debt discount measured by the difference between the face value of its corporate bonds and the fair market value of its preferred stock which it received in exchange for the bonds.

All of the facts have been stipulated and are found accordingly.

National Alfalfa Dehydrating and Milling Company (hereinafter referred to as petitioner or National Alfalfa) is a Delaware corporation with its principal office at the time the petition in this case was filed in Shawnee Mission, Kansas.

National Alfalfa filed its Federal corporate income tax return for the fiscal year ended April 30, 1967, with the district director of internal revenue, Wichita, Kansas.

National Alfalfa was incorporated on May 4, 1946, to engage in the business of dehydrating and milling alfalfa.

Prior to July 23, 1957, it had 47,059 shares of its $50 par value cumulative preferred stock issued and outstanding. The dividend arrearages on each of these shares of preferred stock amounted to $10 as of July 23, 1957.

Petitioner's certificate of incorporation and the preferred stock certificates provided that the preferred stock was redeemable at stated prices depending on the redemption date. After December 1, 1955 the redemption price was $51.

On April 8, 1957, the board of directors of National Alfalfa passed a resolution which authorized $2,352,950 in 5 percent sinking fund debenture bonds to be issued by the corporation in exchange for its outstanding preferred stock and the increase in the par value of its common stock from $1 to $3 a share.[1]

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[1] This resolution provided as follows with respect to the exchange of bonds for preferred stock:

> RESOLVED, that the President or Vice-President and the Secretary or Assistant Secretary of the Company be and they are hereby authorized to enter into a trust indenture with Fidelity-Philadelphia Trust Company of Philadelphia, Pennsylvania, dated, as of July 1, 1957, pursuant to the terms of which there shall be issued $2,352,950.00 principal amount 5% Debentures, due July 1, 1975, which said bonds shall be issued in exchange for shares of the 5% Cumulative Preferred Stock on the basis of $50.00 principal amount of such debentures for each share of preferred stock and that this resolution, when ratified by the shareholders shall constitute authority for said issue, and
>
> RESOLVED, that the Company be authorized to issue warrants for the purchase of the common stock of the Company to each preferred shareholder participating in the exchange of his preferred stock for Debentures of the Company in the reorganization effective August 1, 1957, on the basis of one warrant for each share of Preferred Stock surrendered, said warrants to evidence the right to purchase one-half (½) share of common stock and said warrants to be exerciseable to purchase only full shares of common stock of the Company at a price of $10.00 per share at any time from the date of issue until July 1, 1969 or so long as any debenture bonds re-

The principal business purpose for the 1957 exchange of debentures for preferred stock was to enable National Alfalfa to expand its eastern producing areas. In order to expand into the eastern areas National Alfalfa's credit requirements for carrying inventory were increased by 50 percent. To improve National Alfalfa's credit status this transaction also included the issuance of certain warrants to the cumulative preferred shareholders which permitted the holder to purchase common stock of National Alfalfa at a stated price in order to eliminate the dividend arrearages owed to them. In addition, the cancellation of the preferred stock and elimination of the dividend arrearages, made it possible for National Alfalfa to declare dividends to the common stockholders thereafter.

An indenture dated July 1, 1957, was arranged between National Alfalfa and Fidelity-Philadelphia

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main outstanding, after which date warrants will become void, and

* * * *

RESOLVED, that this resolution and the reorganization and recapitalization contemplated hereby be submitted to a vote of the shareholders, and if adopted by the requisite number of shareholders, all rights and privileges of the 5% Cumulative Preferred Shares heretofore expressed or inherent in the ownership of said Preferred Stock shall cease and determine as of August 1, 1957 except such right to surrender the said shares of stock on the terms herein contained except as otherwise provided by law, and

RESOLVED, that the officers of the Company be hereby authorized to submit the Plan of Reorganization to the Commissioner of Internal Revenue in an attempt to have the said Plan qualified as a tax free reorganization under the Internal Revenue Code of 1954, and

* * * *

Trust Company, as trustee. On behalf of National Alfalfa, Fidelity-Philadelphia Trust Company requested a ruling from the United States Treasury Department. In reply to this request a letter ruling dated May 29, 1957, was issued. This letter stated that no gain or loss would be recognized on the exchange of the $1 par value common stock for $3 par value common stock under the provisions of sections 368(a)(1)(E)[2] and 354(a) but gain or loss would be recognized to the preferred stockholders on the exchange of their preferred stock for debenture bonds.[3]

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[2] All references are to the Internal Revenue Code of 1954 unless otherwise indicated.

[3] The letter ruling stated as follows:

(1) The exchange by the holders of $1. par value common stock for $3. par value common stock, on the basis described above, will constitute a recapitalization and, therefore, a reorganization, within the meaning of section 368(a)(1)(E), of the Internal Revenue Code of 1954. No gain or loss will be recognized to Company as a result of the exchanges.

(2) No gain or loss will be recognized to the holders of common stock as a result of the exchange of common stock (section 354(a)). The basis to each stockholder of the stock received will be the same as the cost or other adjusted basis of the stock surrendered (section 358(a)). The holding period of the stock received will include the holding period of the stock surrendered in the exchange (section 1223).

(3) Assuming but not determining that the 5% debenture bonds to be issued qualify as securities (create a genuine relationship of debtor and creditor), gain or loss will be recognized to the preferred stockholders from the exchange of 5% cumulative preferred stock, par $50., and the dividend arrearage thereon of $10. per share as of June 1, 1957, for debenture bonds and warrants to subscribe for the new common stock at

On July 23, 1957, the holders of cumulative preferred stock of National Alfalfa exchanged that stock for the debenture bonds of National Alfalfa due in 1975. Each unit of the debenture had a fixed maturity value of $50.

The preferred stock received by National Alfalfa in exchange for the debentures was retired and canceled upon the issuance of the bond indebtedness by an entry on National Alfalfa's books debiting preferred stock for $2,352,950 thereby completely eliminating the preferred stock account and crediting the liability account for 18-year 5 percent debentures for the same amount.

$10. per share (section 302(a)). The gain or loss recognized from the exchange will be measured by the difference between the cost or other adjusted basis of the preferred stock surrendered and the fair market values of the debentures and warrants received and such gain or loss will constitute capital gain or loss subject to the applicable provisions and limitations of Subchapter P Part I of Subtitle A of the Code.

The basis of the debentures and the warrants received by the holders of the old preferred stock will be the fair market values used in the determination of the recognizable gain or loss.

(4) The fair market values prevailing on the date the Plan is declared effective are the values to be assigned to the debentures and the warrants received in the exchange.

The preferred stock of National Alfalfa was quoted in the Over-The-Counter Market during the period July 15 to July 30, 1957 as follows:

Date	Bid	Offer	Date	Bid	Offer
July 15	33	35	July 23	32	34
July 16	32	35	July 24	32	35
July 17	32	34	July 25	29	32
July 18	31	34	July 26	30	33
July 19	32	34	July 29	30	33
July 22	31	33	July 30	30	33

The National Stock Summary dated October 1, 1957 shows 100 shares of National Alfalfa wanted on July 9, 1957 at $32 and 100 shares wanted on July 10, 1957 at $33 and 100 shares offered on July 10, 1957 at $35.

On its Federal income tax returns for its fiscal years ended April 30, 1958 through April 30, 1967, National Alfalfa claimed deductions for debt discount expense and in computing the amount of the claimed deduction used a fair market value of $33 per share for the preferred stock exchanged for the bonds. The difference of $800,003 between the face value of the debentures ($2,352,950) and the fair market value of the preferred stock (47,059 shares times $33 per share) ($1,552,947) was amortized over the years 1957 through 1975 and appropriate amounts were taken as deductions each year through April 30, 1967.

The deduction claimed by National Alfalfa each year for debt discount was computed on the basis of the total of two different variables:

1. The unamortized discount of bonds redeemed or repurchased and retired by National Alfalfa in the year of the deduction, and
2. The annual straight line amortization on those bonds still outstanding at the end of the year.

The amounts of deduction for discount taken by National Alfalfa on its Federal income tax returns for its fiscal years ended April 30, 1958 through April 30, 1967 are as follows:

Year ended April 30	Unamortized discount on bonds currently repurchased or redeemed	Straight-line amortization	Total
1958	- 0 -	$37,037.00	$ 37,037.00
1959	$20,104.00	43,273.00	63,377.00
1960	17,007.00	42,310.00	59,317.00
1961	- 0 -	28,743.00	28,743.00
1962	14,062.00	27,751.00	41,813.00
1963	- 0 -	27,751.00	27,751.00
1964	26,624.00	25,562.00	52,186.00
1965	37,903.00	22,168.00	60,071.00
1966	4,139.00	21,761.00	25,900.00
1967	98,824.00	10,980.00	109,804.00
			$505,999.00

As required by the indenture a sinking fund was established in order to secure funds to redeem the debenture bonds. In lieu of making all or any part of the sinking fund payments in cash National Alfalfa is also authorized by the terms of the indenture

in Article VI to deliver outstanding debentures to the sinking fund trustee which have either been redeemed or purchased by National Alfalfa on the open market.

National Alfalfa has at all times been on schedule following the provisions of the sinking fund and is not now nor has at any time pertinent hereto been in default of any of the terms of the indenture. As of April 30, 1967, only 11,626 of the original 47,059 debenture bonds of National Alfalfa remained outstanding, as a result of the sinking fund trustee and National Alfalfa having redeemed or otherwise repurchased and retired the other 35,433 debentures.

Respondent in his notice of deficiency disallowed petitioner's claimed deduction of $109,804 for amortization of bond discount for its fiscal year ended April 30, 1967, and also disallowed $321,657 of claimed loss carryovers from prior years based on the disallowance of petitioner's claimed deductions for amortization of bond discount for its fiscal years ended April 30, 1958, through April 30, 1966.

Petitioner contends that since the maturity value of its debenture bonds issued in exchange for its preferred stock was in excess of the fair market value of the preferred stock it received, the difference is discount which may be prorated or amortized over the life of the bonds and deducted under section 163.

Respondent's position is that the transaction in which petitioner exchanged the bonds for preferred stock was a tax free recapitalization under section 368(a)(1)(E) in which gain or loss is not recognized. Respondent argues that the difference in the face amount of the bonds and the fair market value of the stock is nonrecognizable loss. Respondent also argues that petitioner's issuance of bonds for its own

preferred stock was a redemption of the preferred shares and that under the provisions of section 311 (a) (2), no gain or loss shall be recognized by a corporation on such a distribution. Finally, respondent contends that in any event no bond discount arises when a taxpayer issues its bond in exchange for its stock of a par value equal to the face value of the bond and then cancels the stock.

It is well established that debt discount arising from the issuance of bonds or debt obligations at a price below their par or maturity value is deductible. Respondent's regulations providing that the deduction for bond discount is to be prorated over the life of the bonds [4] has been recognized as valid. *Helvering* v. *Union Pacific Co.*, 293 U.S. 282 (1934). However, there is a division of authority with respect to the question of whether original issue discount can arise where bonds are issued for something other than cash.[5]

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[4] Sec. 1.163-3, Income Tax Regs. (T.D. 6984 filed 12-23-68, (1969-1 C.B. 39) Deduction for bond discount.

(a) *Discount upon issuance.* (1) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. For purposes of this section, the amortizable bond discount equals the excess of the amount payable at maturity (or, in the case of a callable bond, at the earlier call date) over the issue price of the bond (as defined in paragraph (b) (2) of sec. 1.1232-3).

Sec. 1.163-3(d) replaced Reg. sec. 1.61-12(c) which as in effect in 1967 and for many years prior thereto provided in part:

> if bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. * * *

[5] See footnote 8 *infra*.

Respondent's arguments based on section 368(a)(1)(E) and section 311(a)(2) need not be discussed since we are disposing of this case in his favor on another issue.

The major contention of respondent is that in a transaction where a corporation exchanges its bonds for its stock which it then cancels, no bond discount arises. Respondent argues that petitioner did not issue its bonds for "property" but rather merely replaced its paid-in capital represented by its preferred stock by paid-in capital represented by its bonds. Respondent relies on *Erie Lackawanna Railroad Company* v. *United States*, 422 F. 2d 425 (Ct. Cls., 1970) and *Missouri Pacific Railroad Co.* v. *United States*, 427 F. 2d 727 (Ct. Cls., 1970), modified on rehearing 433 F. 2d 1324 (Ct. Cls., 1970), in support of his position. Petitioner attempts to distinguish *Missouri Pacific Railroad Co.* v. *United States*, *supra*, from the present case on its facts. In the *Missouri Pacific* case, bonds of a reorganized company were exchanged for bonds of that company and stocks and bonds of a subsidiary. The Court held that no debt discount arose where the old bonds and stocks and bonds of the subsidiary received in the exchange were equal in face amount to the new bonds issued. Petitioner contends there was no "qualitative" difference in the securities exchanged in the *Missouri Pacific* case whereas in the instant case there is a "qualitative" difference in the bonds issued by petitioner and the preferred stock exchanged for those bonds. Petitioner does not contend that the facts in *Erie Lackawanna Railroad Company* v. *United States*, *supra*, which held that no debt discount arose on the issuance of the taxpayer's bonds for stock in equal face amounts are distinguishable from the facts in the instant case but

argues that the conclusion in that case that the issue price of the stock rather than its market value is the amount to be used in determining whether discount has arisen on the exchange of the bonds for the stock is without a rational basis.*

In our view there is no distinction in substance between the facts in either the *Erie Lackawanna* case or the part of the *Missouri Pacific* case dealing with the exchange of bonds of the new company for bonds of the old company and the instant case. In the *Erie Lackawanna* case when the taxpayer exchanged its $100 debenture bonds for its preferred stock with a par value of $100 and canceled the stock received in the exchange, the fair market value of the stock was less than $100. In holding that the "amount paid for the preferred stock should be considered as the cost of the bond" the Court stated that since the taxpayer had originally received $100 for the preferred stock, it was not "hurt" as a result of the transaction. The Court in the *Missouri Pacific* case extended its holding in *Erie Lackawanna* to cover a bonds-for-bonds

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*We have not discussed petitioner's "what might have been" argument. This argument by petitioner in effect is that if it had issued the bonds for $33 in cash and used the $33 to purchase its outstanding preferred stock, the net result would be the same as an exchange of the bonds for the stock, but there would be no question that it would be entitled to deductions for amortizable bond discount. The simple answer to this contention is that it is not what happened. However, the assumption is not based on any evidence in this case. There is no evidence in this case to show at what price the bonds might have been sold on the open market had they been issued and put up for sale for cash. Also, there is no evidence to indicate that petitioner would have been able to purchase all of its preferred stock on the open market or at what price that quantity of stock could have been purchased other than the $51 at which it could be redeemed.

exchange and bonds exchanged for stock and bonds of a subsidiary. In that case the Court held bond discount to be available where the amount originally paid for bonds was less than the face amount of the bonds issued by the taxpayer in the exchange.[7] Again, the Court looked to the payment received by the taxpayer when the original stocks or bonds were issued to determine whether debt discount arose. In both *Erie Lackawanna* and *Missouri Pacific*, the Court noted that it was not considering the general question of whether debt discount can arise in transactions in which bonds are issued for property.[8] We

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[7] In the case of certain stock which had an issue price less than the face amount of the bonds but a worth greater than such issue price, the Court held on rehearing that no bond discount arose from the transaction. In its opinion on the motion for rehearing the Court held the face amount of the stock to be the "floor" but not the "ceiling" in calculating whether the bonds issued for the stock were issued at a discount.

[8] In *Erie Lackawanna Railroad Company* v. *United States*, 422 F. 2d 425, 430-431 (Ct. Cls., 1970), the following statement was made as to this question:

> In addition, we have failed to consider the conflict of whether debt discount can arise in instances where bonds are issued for property. Since we feel that, in the bond discount area, a corporation's own stock comprises a category completely separate from cash and other types of property, we have found it unnecessary and indeed unwise to involve ourselves, at this time, in this rather sticky issue. *Compare* Nassau Lens Co. v. Commissioner, *supra*; American Smelting & Ref. Co. v. United States, *supra*; Industrial Dev. Corp. v. United States, *supra*; *with* Southern Natural Gas Co. v. United States, supra; Montana Power Co. v. United States, 159 F. Supp. 593, 141 Ct. Cl. 620, cert. denied, 358 U.S. 842, 79 S.Ct. 28, 3 L.Ed. 2d 76 (1958); Montana Power Co. v. United States, 232 F. 2d 541 (3d Cir.), cert. denied, 352 U.S. 843, 77 S.Ct. 51, 1 L.Ed.2d 59 (1956) (dictum). Instead, we feel

that the problem can be better resolved when a case arises in which bonds are exchanged for property other than the stock of the issuing corporation.

In *Missouri Pacific Railroad Company* v. *United States*, 427 F. 2d 727, 731 [footnote 7] (Ct. Cls., 1970), the conflict of authority on this issue was discussed as follows:

7. We do not mean to imply by this statement that we are now holding that debt discount is available where bonds are issued for property (other than the corporation's own securities). In fact there appears to be a definite split of authority on this question with Nassau Lens Co. v. Commissioner of Internal Revenue, 308 F. 2d 39 (2d Cir. 1962), and American Smelting & Ref. Co. v. United States, 130 F.2d 883 (3d Cir. 1942), holding that debt discount is available where bonds are issued for property, and Southern Natural Gas Co. v. United States, 412 F.2d 1222, 188 Ct.Cl. 302 (1969), Montana Power Co. v. United States, 159 F. Supp. 593, 141 Ct.Cl. 620, cert. denied 358 U.S. 842, 79 S.Ct. 23, 3 L.Ed. 2d 76 (1958), and Montana Power Co. v. United States, 232 F.2d 541 (3d Cir.), cert. denied 352 U.S. 843, 77 S.Ct. 51, 1 L.Ed.2d 59 (1956) (dictum), stating that debt discount is not so available. We are simply saying that, as between the situation where a corporation issues bonds for its own securities and where a corporation issues bonds for other types of property, we can better understand how fair market value could be applied to the latter situation but not to the former—assuming, for the moment, that debt discount would be available in the latter situation.

Sec. 1232(b)(2) defining issue price of bonds was amended by sec. 413(b) of the Tax Reform Act of 1969, P.L. 91-172 "in order to clarify the situations in which original issue discount may arise * * *." S. Rept. No. 91-552, 91st Cong., 1st Sess. (1969) 1969-3 C.B. 517. This provision is made applicable to bonds issued after May 27, 1969, other than those issued pursuant to a written commitment binding on May 27, 1968, and at all times thereafter. Sec. 413(e) P.L. 91-172.

Sec. 1232(b)(2) as amended by the 1969 Tax Reform Act

are impressed with the reasoning of the Court in *Erie Lackawanna* and *Missouri Pacific*. The rationale of our holdings in *375 Park Avenue Corporation*, 23 B.T.A. 969 (1931), and *Liquid Carbonic Corporation*, 34 B.T.A. 1191, 1196 (1936), and cases there cited,

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applicable to bonds issued after May 27, 1969 (sec. 413 of P.L. 91-172) provides in part:

> In the case of a bond or other evidence of indebtedness or an investment unit as described in this paragraph *(other than a bond or other evidence of indebtedness or an investment unit issued pursuant to a plan of reorganization within the meaning of section 368(a)(1)* or an insolvency reorganization within the meaning of section 371, 373 or 374), which is issued for property and which—
>
> (A) is part of an issue a portion of which is traded on an established securities market, or
>
> (B) is issued for stock or securities which are traded on an established securities market,
>
> the issue price of such bond or other evidence of indebtedness * * * shall be the fair market value of such property. Except in cases to which the preceding sentence applies, the issue price of a bond or other evidence of indebtedness * * * which is issued for property (other than money) shall be the stated redemption price at maturity. [Underscoring supplied.]

This provision is, of course, not applicable to the instant case. If it were applicable, respondent's argument under sec. 368(a)(1)(E) would have relevance whether bond discount is considered to be deductible as interest or as loss and we would dispose of the case by determining that the bonds were issued pursuant to a plan of reorganization under sec. 368(a)(1)(E) even though the exchange was not one in which there was nonrecognition of gain or loss.

Respondent in his reply brief states that in the instant case he is not contending that bond discount can never arise where bonds are issued for property but only that no such discount arises under the facts of this case.

support the reasoning in those Court of Claims' cases. In the *375 Park Avenue* and *Liquid Carbonic* cases, we concluded that where bonds were retired by a corporation by issuance of its stock, the transaction did not amount to "payment" of the bonds so as to entitle the corporation to deduct unamortized bond discount and that no loss to the corporation resulted from the transaction. The instant case, as well as the *Erie Lackawanna* and *Missouri Pacific* cases, is obviously actually distinguishable from the *375 Park Avenue* and *Liquid Carbonic* cases. However, the same reasoning that supports the conclusion that retiring a bond by issuing stock for it is not equivalent to payment of the bond in cash or property other than stock of the corporation retiring the bond also supports the conclusion that a bond issued for a corporation's own preferred stock, par for par, has not been issued at a discount. The payment received by the corporation for the bond is the amount originally paid in for the stock. The transaction from the corporation's standpoint is merely the exchange of one form of interest in the corporation for another. We recognize, as petitioner contends, that petitioner was not obligated to pay back to its preferred stockholders the $50 they had paid in for the stock except upon redemption of the stock or liquidation of the company and that upon liquidation the payment would be subordinate to the payment to creditors of the corporation. These facts may affect the value of the stock as compared to the bond but they do not affect the amount paid to the corporation for the bond. The stock had no "value" to petitioner aside from the $50 it had originally received for it. This is the rationale of the *Erie Lackawanna* and *Missouri Pacific* cases. Bonds issued in

exchange for stock or bonds of the issuing company are distinguishable from bonds issued for a type of property which was never represented by a previous cash payment to the issuing company and which is retained by the issuing company.[9] After the transaction here involved, which included the issuance of the bonds and the cancellation of the stock, was completed petitioner had no "property" paid for its bonds unless the $50 paid in for the stock is the property paid in for the bonds.

Since we agree with the conclusions in the *Erie Lackawanna* and *Missouri Pacific* cases, and those conclusions are in effect supported by our decisions in *375 Park Avenue Corporation, supra*, and *Liquid Carbonic Corporation, supra*, we would without further discussion apply that reasoning in the instant case and hold that petitioner's bonds were not issued at a discount, except for the recent decision of the United States Court of Appeals for the Tenth Circuit to which an appeal in this case would lie, in *Atchison Topeka & Santa Fe R. Co.* v. *Commissioner*, 443 F. 2d 147 (C.A. 10, 1971). The *Atchison Topeka & Santa Fe* case involved a deduction for bond discount claimed by the taxpayer for the year 1950 on its 100-year debenture bonds issued in 1895. The bonds had been issued in a reorganization, the face amount of the new bonds being equal to the face amount of old bonds which were surrendered as a part of the reorganization but greater than the fair market value of the old bonds. The Government contended that the bonds of the taxpayer (the new company in the reorganization) were issued in partial payment for

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[9] See footnote 8 for similar comments in the *Missouri Pacific* case.

the physical properties of the old company in the amount of the purchase price of the assets for which issued and therefore no discount was incurred. The Court held that the sale of the assets for the bonds was merely one step in a reorganization and affirmed the holding of the lower court that the taxpayer's bonds had been issued in exchange for bonds of the old company. In the alternative the Government contended that even assuming the bonds of the taxpayer were exchanged for the bonds of the old company, no discount arose "because none may be imputed where discount is not specified in a bonds-for-property exchange." The Court rejected the Government's contention and concluded that since the face amount of the bonds issued by the taxpayer exceeded the fair market value of the old bonds for which they were exchanged, "economic and business reality" conforms with the view that to the issuer bond interest is reflected both in the stated rate of interest and by the amount below par received by the issuer when the bonds are distributed. The Court in reaching its conclusion cited the *Missouri Pacific* case and the *Erie Lackawanna* case in a footnote but did not discuss either of those cases. The Court's discussion of the issue of whether bond discount might arise when a company exchanged new bonds for old bonds in a reorganization consisted of the following paragraph (443 F. 2d at 152-153):

> Perhaps the strongest authority the Government cites for its argument that discount may not arise in a bonds-for-property transaction is the analysis in an opinion by Judge Kalodner, joined by Judge Staley, in *Montana Power Co.* v. *United States* [56-1 USTC par. 9402], 232 F. 2d 541, 545 (3rd Cir. 1956), in which the

other five members of the Court sitting *en banc* did not join. Upon reviewing the history and rationale of the Regulation authorizing the deduction for bond discount and cases considering the Regulation, Judge Kalodner concluded that the Regulation was never intended to be applicable in a bonds-for-property transaction. The position expressed by Judge Kalodner was adopted by the Court of Claims in *Montana Power Co.* v. *United States* [58-1 USTC par. 9332], 159 F. Supp. 593 (1958).[5] However, the contrary view of Judge Goodrich in *American Smelting & Refining Co.* v. *United States* [42-2 USTC par. 9670], 130 F. 2d 883, 885 (3rd Cir. 1942) is more persuasive: "We believe that the discount is still to be treated as additional interest when the subject matter of the loan is stock instead of cash." *Accord, Nassau Lens Co.* v. *United States* [62-2 USTC par. 9723], 308 F. 2d 39, 44 (2nd Cir. 1962); *Industrial Development Corp.* v. *United States* [56 USTC par. 10,066), 51 A.F.T.R. 1514 (N.D. Ill. 1966); *Southern Fertilizer & Chem. Co.* v. *Edwards* [55-1 USTC par. 49,133], 167 F. Supp. 879 (M.D. Ga. 1955). [Footnote omitted.]

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[5] But compare *Erie Lackawanna R. R.* v. *United States* [70-1 USTC par. 9245], 422 F. 2d 425, 430 (Ct. Cl. 1970) and *Missouri Pacific R. R.* v. *United States* [70-1 USTC par. 9457], 427 F. 2d 727, 731 (Ct. Cl. 1970).

Respondent attempts to distinguish the *Atchison, Topeka & Santa Fe* case from the instant case on its facts, primarily by the statements that (1) "The Court is a bit ambivalent as to whether the 'new' company issued its bonds for the bonds of the old

company or for the property of the old company" and (2) "What the 'new' company received for its stock and debentures was the assets of the old company, including the newly invested capital, subject to the liabilities which resulted from the negotiations."

Respondent follows his statements by an argument that the *Atchison, Topeka & Santa Fe* case involved an entity purchasing the assets of another corporation which purchased the bonds to merge them with the assets of the old company because the bonds were liens on those assets. Respondent contends that these facts distinguish the *Atchison, Topeka & Santa Fe* case from the instant case.

Finally, respondent argues that the decision in the *Atchison, Topeka & Santa Fe* case if not factually distinguishable from this case, is invalid.

The Court in *Atchison, Topeka & Santa Fe* stated the Government's first argument to be "that as a matter of law taxpayer's bonds were issued in partial payment of the negotiated and agreed purchase price for the assets of the old company, in substance as well as in fact, and therefore no discount was incurred." The Court rejected this argument of the Government before discussing the Government's alternative argument. The Tenth Circuit's rejection of this contention of the Government must be viewed in the light of the statements made by the trial court to the jury when the case was submitted to the jury by the District Court. [*The Atchison, Topeka and Santa Fe Railway Company, a corporation* v. *United States*, an unreported case (D. Kans. 1969, 69-2 USTC par. 9740; 24 A.F.T.R. 2d 69-5963].[10]

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[10] The following are excerpts from the trial court's charge to the jury in *The Atchison, Topeka and Santa Fe Railway Company, a corporation* v. *United States*, an unreported case

(D. Kans. 1969, 69-2 USTC par. 9740; 24 A.F.T.R. 2d 69-5963):

> The Court has held as a matter of law that the one hundred year general and adjustment mortgage bonds issued in 1895 by the plaintiff (Atchison, Topeka and Santa Fe Railway Company), were exchanged for the general mortgage bonds issued by the "old company" (Atchison, Topeka and Santa Fe Railroad Company). It is for you, the jury, to determine as a matter of fact (1) whether the exchange of the bonds of the Railway Company (referred to as "the new bonds") for those of the Railroad Company (the old bonds) give rise to a discount; and (2) the amount of such discount.
>
> So the factual issues remaining for you to decide in this case are:
>
> 1. What was the fair market value of the old company's bonds which plaintiff received in exchange for its general and adjustment mortgage bonds?
>
> 2. If the fair market value of the bonds received was less than the principal amount of said bonds, that is, less than $147,620,250, was all or any part of the difference discount?
>
> * * * *
>
> There is no burden upon the government to prove that it is correct in retaining the taxes paid by the plaintiff with its income tax return. Rather, the burden is upon the plaintiff to establish by a preponderance of the evidence that the fair market value of the old general mortgage bonds was less than the par value of the new general and adjustment mortgage bonds. Plaintiff must also establish by a preponderance of the evidence that such a difference, or any part of such difference, was discount. In order to do this, plaintiff must show by a preponderance of the evidence that its general and adjustment mortgage bonds were issued under circumstances which would be equivalent of a discount. In other words, that the circumstances surrounding the issuance of its bonds were typical of the circumstances that might compel a corporation to discount its bonds.
>
> * * * *

The distinction in the *Atchison, Topeka & Santa Fe* case and the instant case is that in the former no argument was presented by the Government or considered by the Court as to whether in fact the "property" received by the new company for its bonds was the "bonds of the old company at their fair market value" or the money originally paid for those bonds. For this reason the *Atchison, Topeka & Santa Fe* case is as a matter of law distinguishable from the instant case, the *Erie Lackawanna* case, and the *Missouri Pacific* case. We will not speculate on what conclusion the Tenth Circuit would have reached in *Atchison, Topeka & Santa Fe*, had the issue presented to it been issuance of new bonds for old bonds of the same company as distinguished from issuance of bonds for other property. The case of *American Smelting and Refining Co.* v. *United States*, 130 F. 2d 883 (C.A. 3, 1942), was the only case discussed by the Court in *Atchison, Topeka & Santa Fe* which involved an exchange of bonds for stock or securities. That case involved bonds exchanged for stock of a subsidiary which the Court deciding that case considered to be the same as any other property. Because the issue presented to us differs from the legal issues presented to and decided by the Tenth Circuit in the *Atchison, Topeka & Santa Fe* case, we do not consider our holding in *Jack E. Golsen*, 54 T.C. 742 (1970), affirmed —— F. 2d —— (C.A. 10, June 18, 1971), to require us to hold for petitioner in the instant case on the basis of the decision of the Tenth Circuit in the *Atchison, Topeka & Santa Fe* case. In *Jack E. Golsen* (54 T.C. at 757), we held that we are required to "follow a Court of Appeals' decision which is squarely in point where appeal from our decision lies to that Court of Appeals and to that

court alone." For the reasons we have heretofore discussed we do not consider the decision of the Tenth Circuit in *Atchison, Topeka & Santa Fe* to be "squarely in point" with the instant case.[11]

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[11] If we attempted to follow precisely the holding of the Tenth Circuit in *Atchison, Topeka & Santa Fe*, even though that holding was arrived at without consideration of one of the primary issues presented in the instant case, it would not follow that we would conclude that petitioner's bonds were issued at a discount of $17 a bond, for which discount petitioner contends. In the *Atchison, Topeka & Santa Fe* case the questions of the fair market value of the old company's bonds which the taxpayer received in exchange for its bonds, and if the fair market value of the old bonds was less than the principal amount of the new bonds whether any part of the difference was bond discount, were left to the jury. In the instant case respondent apparently does not contend that the fair market value of the preferred stock was other than $33 a share in July based on asked and bid prices for small quantities but does contend that this price in no way indicates the fair market value of the bonds had they been put up for sale for cash. Under the holding of the Court in the *Atchison, Topeka & Santa Fe* case, we would have to determine whether all of the circumstances surrounding the issuance of the bonds were "typical of the circumstances that might compel a corporation to discount its bonds." Our conclusion that under the circumstances of this case the $50 originally paid in for the preferred stock is the amount to be considered as paid in for the debenture bonds, might be considered to be a holding that no part of any difference which might exist between the fair market value of the National Alfalfa preferred stock and the face amount of the bonds issued in exchange therefor has been shown to be bond discount under the circumstances surrounding the issuance of the bonds in this case. If our conclusion that the bonds under the circumstances of this case were not issued at a discount is considered to be such a holding, then our conclusion in the instant case is supported by, and in no way in conflict with the *Atchison, Topeka & Santa Fe* case. There is no affirmative evidence in

We therefore conclude that petitioner is not entitled to bond discount amortization based on the difference in the $50 face value of its bonds issued in exchange for its preferred stock and the fair market value of the stock at the date of issue of the bonds but rather that the bonds were issued for stock which represented a $50 payment to petitioner.

Reviewed by the Court.

Decision will be entered for respondent.

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this case of circumstances surrounding the issuance of the bonds which would indicate what the fair market value of the bonds were at the time they were issued.

APPENDIX B

UNITED STATES COURT OF APPEALS
TENTH CIRCUIT

January Term—1973

No. 72-1125

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY, PETITIONER-APPELLANT

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT-APPELLEE

ON APPEAL FROM THE UNITED STATES TAX COURT

(Docket No. 1081-70)

Charles White Hess (Ronald B. Stang and Linde, Thomson, Van Dyke, Fairchild & Langworthy on the briefs) for petitioner-appellant.

Ernest J. Brown, Atty., Dept. of Justice, (Scott P. Crampton, Asst. Atty. General, and Meyer Rothwacks, Atty., Dept. of Justice, on the brief) for respondent-appellee.

Stuart S. Opotowsky, Alan D. Berlin, Walter J. Rockler, Julius M. Greisman, Richard L. Hubbard, and Arnold & Porter, of counsel, on the brief for Norton Simon, Inc., amicus curiae.

Before PHILLIPS, HILL and HOLLOWAY, Circuit Judges.

PHILLIPS, Circuit Judge.

National Alfalfa Dehydrating and Milling Company, hereinafter called National Alfalfa, was incorporated under the laws of Delaware on May 4, 1946. It was authorized to engage and did engage in the business of dehydrating and milling alfalfa.

The question presented in this case is whether National Alfalfa incurred amortizable and deductible bond issue discount, deductible as interest paid, when it issued its 18-year, five per cent, sinking fund debenture bonds, hereinafter referred to as debentures, each for the principal sum of $50, to the preferred stockholders in exchange for their preferred stock, on the basis of one $50 debenture for each share of preferred stock of the par value of $50, when at the date of the exchange the fair market value of the preferred stock was only $33 per share.

Prior to July 23, 1957, National Alfalfa had issued an outstanding 47,059 shares of $50 par value, five per cent, cumulative preferred stock in an aggregate par value amount of $2,352,950, and as of that date there was a dividend arrearage on each of such shares of $10. Such preferred shares were redeemable at the discretion of National Alfalfa, in whole or in part, at prices ranging from $53 per share for shares redeemed prior to December 1, 1949, to $51 per share for shares redeemed after December 1, 1955, plus accumulated and unpaid dividends down to the date of redemption.

When redeemed, such preferred shares could not be reissued by National Alfalfa, but had to be cancelled and retired by it.

National Alfalfa was required to set aside annually after September 1, 1948, 20 per cent of its consolidated net earnings, after a payment of accrued

dividends on its outstanding preferred stock, for the purpose of redeeming preferred shares, as long as any were outstanding. However, such preferred shares could not be redeemed with funds in the sinking fund, nor purchased or acquired for value by National Alfalfa at any time when there were dividend arrearages thereon, unless consented to by the holders of 50 per cent of the preferred shares, or unless National Alfalfa notified all of its preferred shareholders of its desire to purchase such shares and invited them to tender offers.

On April 8, 1957, the Board of Directors of National Alfalfa adopted several resolutions, which are set out in Note 1 hereto.

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[1] The text of the resolutions is as follows:

"RESOLVED, that the officers of the Company, be and they are hereby authorized to effectuate a reorganization of the Company by way of recapitalization, and

"RESOLVED, that the President or Vice-President and the Secretary or Assistant Secretary of the Company be and they are hereby authorized to enter into a trust indenture with Fidelity-Philadelphia Trust Company of Philadelphia, Pennsylvania, dated, as of July 1, 1957, pursuant to the terms of which there shall be issued $2,352,950.00 principal amount 5% Debentures, due July 1, 1975, which said bonds shall be issued in exchange for shares of the 5% Cumulative Preferred Stock on the basis of $50.00 principal amount of such debentures for each share of preferred stock and that this resolution, when ratified by the shareholders shall constitute authority for said issue, and

"RESOLVED, that the Company be authorized to issue warrants for the purchase of the common stock of the Company to each preferred shareholder participating in the exchange of his preferred stock for Debentures of the Company in the reorganization effective August 1, 1957, on the basis of one warrant for each share of Pre-

ferred Stock surrendered, said warrants to evidence the right to purchase one-half (½) share of common stock and said warrants to be exercisable to purchase only full shares of common stock of the Company at a price of $10.00 per share at any time from the date of issue until July 1, 1969 or so long as any debenture bonds remain outstanding, after which date warrants will become void, and

"RESOLVED, that the Company increase the par value of its shares from $1.00 to $3.00 and that the amount of $1,580,000.00 be transferred from Paid-In-Capital to the Capital Account in order to effectuate this resolution and reflect the increase in par value of the Common Stock, and

"RESOLVED, that the Articles of Incorporation of the Company be amended by changing Article FOURTH to read as follows:

> " 'The total number of shares of stock which the Corporation will have authority to issue is 1,000,000 shares of Common Stock of the par value of $3.00 per share.
>
> The minimum amount of capital with which the Corporation will commence business will be $1,000.00.'
>
> "1. Each share of Common stock shall be entitled to one vote per share in any matter requiring a vote of shareholders and each share shall be entitled, upon any liquidation, dissolution, or winding up of the affairs of the Corporation, whether voluntary or involuntary, to participant pro-rata in the assets available for distribution.
>
> "2. No holder of shares of stock of the Corporation shall be entitled, as such, to subscribe to or purchase any additional shares of stock, whether now or hereafter authorized, or obligations convertible into any class or classes of stock, or shares of stock of any class convertible into any class or classes, or obligations, shares of stock or other securities carrying warrants or rights to subscribe to shares of

stock of the Corporation of any class or classes, in any case whether now or hereafter authorized, but any and all shares of stocks, bonds, debentures or other securities or obligations, whether or not convertible into stock or carrying warrants or rights entitling the holders thereof to subscribe to stock may be issued, sold or disposed of from time to time by the Board of Directors to such persons, firms or corporations and for such consideration, so far as may be permitted by law, as it shall from time to time in its absolute discretion determine, without offering the same to the holders of shares of stock of the Corporation or any class then outstanding.

"3. The Company shall be entitled to issue warrants for the purchase of common stock on such terms as the Board of Directors may determine but such warrants when issued shall be binding on future actions of the Board of Directors and the terms thereof shall not be altered, amended or repealed without the consent of such warrant holders, AND

"RESOLVED, that this resolution and the reorganization and recapitulation [sic] contemplated hereby be submitted to a vote of the shareholders, and if adopted by the requisite number of shareholders, all rights and privileges of the 5% Cumulative Preferred Shares heretofore expressed or inherent in the ownership of said Preferred Stock shall cease and determine as of August 1, 1957, except such right to surrender the said shares of stock on the terms herein contained except as otherwise provided by law, and

"RESOLVED, that the officers of the Company be hereby authorized to submit the Plan of Reorganization to the Commissioner of Internal Revenue in an attempt to have the said Plan qualified as a tax free reorganization under the Internal Revenue Code of 1954, and

"RESOLVED, that the officers of the Company be hereby authorized to incur any and all necessary expenses to effectuate the Plan of Reorganization approved and adopted by this meeting of the Board of Directors."

The Board of Directors, by such resolutions, approved certain corporate actions, which, if approved by a two-thirds vote of each class of its shareholders and carried out, would constitute a reorganization of National Alfalfa within the meaning of 26 U.S.C.A. § 368(a)(1)(E). Such actions were:

1. The entering into of a trust indenture with Fidelity-Philadelphia Trust Company of Philadelphia, Pennsylvania, as trustee, dated July 1, 1957, pursuant to the terms of which there would be issued $2,352,950 principal amount five per cent debentures, due July 1, 1975, and such debentures would be exchanged for all the shares of the outstanding cumulative preferred stock of National Alfalfa on the basis of one debenture for the principal amount of $50 for each share of such preferred stock of the par value of $50;

2. The issuance to each preferred stockholder participating in the exchange of his preferred stock for debentures of warrants effective August 1, 1957, for the purchase of common stock of National Alfalfa, on the basis of one warrant for each share of preferred stock exchanged, such warrants evidencing the right to purchase one-half share of common stock, but exercisable only for the purchase of full shares of such common stock at $10 per share at any time from the date of issue of such warrants to July 1, 1969; such warrants to be issued to and accepted by preferred stockholders participating in the exchange in lieu of the arrearage of cumulative dividends on their preferred stock;

3. (a) The amendment of the articles of incorporation of National Alfalfa, so as to provide for the issuance only of common stock;

(b) Increasing the number of shares of common stock from 763,000 to 1,000,000, and increasing the par value of the stock from $1 to $3.

The principal purpose of the reorganization was to enable National Alfalfa to extend easterly the territory in which it did business and effect a 50 per cent increase in its borrowing credit, which would be required by it for carrying the increased inventory which would result from such expansion. Such increase in the borrowing credit of National Alfalfa would be accomplished by issuing the five per cent debentures to the preferred stockholders in exchange for their preferred stock and the issuance to the preferred stockholders of the warrants to purchase common stock in discharge of the cumulative dividend arrearage.

The resolutions adopted by the Board of Directors of National Alfalfa were duly approved by the requisite number of votes of each class of stockholders at the regular annual meeting of National Alfalfa, held on July 23, 1957, and thereafter all of such resolutions were carried out.

National Alfalfa delivered to each of its preferred stockholders one $50, five per cent, debenture for each share of preferred stock held by such stockholders, and each of such stockholders delivered to National Alfalfa all of the shares of preferred stock held by him, and National Alfalfa retired such preferred stock.

In replying to a request for a ruling by Fidelity-Philadelphia Trust Company, the Treasury Department said in a letter to the Trust Company that no gain or loss would be recognized on the exchange of the $1 par value common stock for $3 par value common stock under the provisions of § 368(a)(1)(E) of

the Internal Revenue Code of 1954, but gain or loss would be recognized to the preferred stockholders on the exchange of their preferred stock for debenture bonds.

National Alfalfa also delivered to each of such preferred stockholders and each of them accepted warrants to purchase common stock of National Alfalfa, as set forth above, in satisfaction of the dividend arrearage on his preferred stock.

The indenture required that National Alfalfa should create a sinking fund for the retirement of the debentures by the following provision:

> "The Company (National Alfalfa) covenants and agrees that on or before the expiration of 90 days after the end of each fiscal year of the Company commencing with the fiscal year ending April 30, 1959, it will pay to the Trustee as and for a contingent sinking fund for the redemption of Debentures at the sinking fund redemption price of 100% of the principal amount of the Debentures so to be redeemed, together with accrued interest to the redemption date, a sum in lawful money of the United States of America sufficient to redeem $196,080 principal amount of said Debentures, provided that in any year when the Consolidated Net Income is insufficient to redeem $196,080 principal amount of said Debentures the amount required to be paid over to the Trustee shall be 100% of such Consolidated Net Income and the difference between that sum and $196,080 shall accumulate to be paid from the Consolidated Net Income of subsequent years and provided further that the Company must commence the accumulation of income for sinking fund purposes by setting

aside 100% of Consolidated Net Income up to $196,080 in each year commencing with the year beginning May 1, 1957."

National Alfalfa has never been in default in the performance of anything required to be done by it by the terms of the debentures and the indenture.

On April 30, 1967, only 11,626 of the original debentures issued by National Alfalfa remained outstanding, and it had redeemed or otherwise repurchased and retired the other 35,433 debentures issued by it.

As shown by over-the-counter bids to purchase and offers to sell, the fair market value of each share of the preferred stock on July 23, 1957, was $33.

The debentures expressed unconditional and legally enforceable obligations on the part of National Alfalfa to pay the face amount thereof, with accrued interest, at the times and in the manner provided therein.

The indenture provided that:

"This Indenture and the Debentures issued hereunder shall be subordinate only to current bank borrowings for inventory purposes which obligations mature by their original terms in less than twelve months and obligations of the Company (National Alfalfa) to suppliers of materials, services and labor incurred in the normal course of the Company's business and reasonably required in its operations, which obligations are due and payable when billed, and to any existing liens, encumbrances, mortgages, conditional sales agreements, or pledges, or any replacement, renewal, or extension thereof * * *"

and, unless consented to by the holders of at least 66⅔ per cent of the debentures outstanding when done, it should not be subordinated to any funded debt created, issued, assumed, or guaranteed by National Alfalfa or any subsidiary thereof, with certain enumerated exceptions.

The indenture contained many other provisions for the protection of the priority of the debentures and the rights of the debenture holders, but it would unduly lengthen this opinion to set them out in detail.

In its income tax returns for its fiscal years ending April 30, 1958, through April 30, 1967, National Alfalfa claimed deductions for interest paid by reason of the debenture discount alleged to have resulted from the difference between the fair market value of $33 of the preferred stock on July 23, 1957, and the face amount of the debentures then issued by it to the holders of its preferred stock. These deductions were computed on the basis of straight line amortization of the interest discount and the amortized amounts with respect to debentures retired in those years. The deductions in earlier years were included in losses carried over to the fiscal year ending April 30, 1967.

The Commissioner of Internal Revenue disallowed National Alfalfa's claimed deduction of $109,804 for interest paid, resulting from debenture discount for its fiscal year ending April 30, 1967, and also disallowed $321,657 of claimed deductions for interest paid, resulting from like discounts for the fiscal years ending April 30, 1958, through April 30, 1966, and determined deficiencies accordingly. Upon National Alfalfa's petition to the Tax Court to review the action of the Commissioner, the Tax Court affirmed the deficiencies asserted by the Commissioner. From the

decision of the Tax Court, National Alfalfa has appealed to this court.

The decision of the Tax Court was based on the asserted proposition that where a corporation has issued its five per cent cumulative preferred stock at a stated par value (here, $50 per share) and thereafter issues its $50 debentures obligating it to pay the principal thereof at the times stated therein, and in the indenture under which the debentures were issued, together with interest at a stated percentage (here, five per cent) at the times stated in the debentures (here, semiannually), and exchanges such debentures for its preferred stock on the basis of one debenture for each share of preferred stock, although the market value of the preferred stock is less than its par value at the time of the exchange (here, $33 per share, or $17 less), thus giving the preferred shareholders a discount from the stated principal amount of the debentures (here, a discount of $17 per share), a corporation issuing the debentures (here, National Alfalfa) is not entitled to a discount reduction as for interest paid, amortized over the life of the debentures, for the reason it received for each preferred share at the time it was issued the identical amount of the stated principal payable under each debenture and therefore suffered no loss. And it so held; notwithstanding while the Treasury Regulations originally treated bond discount as a loss, since prior to 1957 they have treated it as interest paid,[2] which is supported by respectable authority, as we shall hereafter show.

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[2] See American Smelting & Refining Co. v. United States, 3 Cir., 130 F.2d 883, 885 (1942); Treas. Reg.. 33, Rev. Art. 150; Treas. Reg. 45, Art. 554(3)(a); Treas. Reg. 62, Art. 545(3)(a); Treas. Reg. 65, Art. 545(3)(a). The Treasury

The applicable Regulation in effect during the taxable year here involved is Treas. Reg. § 1.61-12(c)(3), T.D. 6272, 1957-2 Cum. Bull. 18, 32, which in part here pertinent reads:

> "If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds."

Section 1.61-12(c)(3) was amended in 1968 by T.D. 6984, 1969-1 Cum. Bull. 38, and the pertinent language of the former Regulation was carried over to current Treas. Reg. § 1.163-3(a)(1).

A taxpayer has the unqualified right under the Federal Income Tax statutes to deduct from his gross income in a tax year interest actually paid in such year in a bona fide transaction.

As above stated, the Treasury Department, at all times here pertinent, has held that bond or debenture discount is deductible, not as a loss, but as interest paid, amortized over the life of the bond or debenture.

And as we shall show, infra, with the exception of the Court of Claims, the courts that have passed on the question have held that bond or debenture discount arises when the issuer of bonds or debentures exchanges them for preferred stock or securities theretofore issued by it, of less value than such bonds or debentures, and that such difference in value is deductible as interest prorated over the life of the bonds or debentures.

Assume that National Alfalfa sold 200 of its $50 debentures to John Doe at a discount of $17 per

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Regulation in effect during the taxable year here involved is § 1.61-12(c)(3), T.D. 6272, 1957-2 Cum. Bull. 18, 32.

debenture and received $6,600 for such debentures; and in the same tax year that it sold such debentures, it purchased from one of its preferred stockholders 200 shares of its $50 par value preferred stock at the market price of $33 per share. Could there be any doubt that National Alfalfa could deduct from its gross income the $17 discount on each of such debentures so sold as interest paid, amortized over the life of the debentures? We think the answer is obviously "No." Yet the $17 discount, plus $33, is exactly the same amount National Alfalfa received for such preferred shares when it sold them.

Assume the same facts stated in the above example, except National Alfalfa sold such 200 debentures at a discount of $17 per debenture to one of its preferred stockholders; and from the same stockholder in the same tax year purchased 200 shares of its preferred stock for $33 per share. Would there be any doubt of the right of National Alfalfa to likewise deduct from its gross income such $17 discount as interest paid, amortized over the life of the debentures? Again, we think the answer is obviously "No," yet as in the first example the $17 discount, plus $33 per share, is the same amount National Alfalfa received for each share of such preferred stock when it sold it.

In substance, there is no difference between the facts in the instant case and the facts in the second example stated above.

Hence, we hold that the decisions of the Commissioner and the Tax Court in the instant case are based on a nonapplicable premise, viz, that National Alfalfa suffered no loss.

At this point, we think it would be helpful if we show what the result would be if National Alfalfa

were permitted to deduct as interest amortized or prorated over the life of the debentures, which was 18 years, the difference between $50, the principal amount of each debenture, and $33, and market value of each certificate of preferred stock, or $17. That amount, prorated over the life of the debentures, would be 95 cents per year on each debenture, and would equal interest thereon at the rate of .019 per year. While the discount, in effect, would be paid in advance, the total deduction could not be taken in the tax year in which the exchange took place. It would have to be amortized over the life of the debentures. The picture looks quite different when the result is thus broken down.

The Tax Court relied principally on the decisions of the Court of Claims in Erie Lackawanna Railroad Company v. United States, 422 F.2d 425 (1970), and Missouri Pacific Railroad Company v. United States, 427 F.2d 727 (1970).

In the former case, the Railroad Company, after being authorized so to do by the Interstate Commerce Commission, exchanged its five per cent debentures, due January 1, 2020, for shares of Series "A" five per cent preferred stock. The basis of the exchange was one income debenture in the principal sum of $100 for one share of preferred stock having a par value of $100. The market value of the preferred stock at the time of the exchange of the debentures for stock was $22,558,224.46, which was $5,217,975.54 less than the $27,776,200 maturity value of the debentures. The Railroad Company claimed such difference represented bond discount and was deductible as interest paid, amortized over the life of the debentures. The Court of Claims held that the Railroad Company was not entitled to deduct such discount,

since the amount received by it for its preferred stock when issued was the same as the principal amount of the debentures, and therefore it suffered no loss in the exchange. In the opinion, the court said:

> "The position which this court does take in regard to the issue at hand is that since plaintiff was exchanging $100 debentures for preferred stock for which it had already received $100 in value, then plaintiff lost nothing as a result of the transaction. Since there was no actual difference between the face value of the debentures and the amount received in return for them ($100 preferred stock), there was no discount which could be amortized over the life of the bonds. The fact that the preferred stock had a market value less than $100 at the time of the exchange is of no consequence in this type of transaction where the plaintiff is purchasing its own stock. What is important in this case is the value received for the stock at the time of its issuance. Since plaintiff issued its stock for $100 per share and carried the stock on its books at this amount, this is the figure which should be used to determine whether a discount has arisen. * * *"

In the latter of the two cases, Missouri Pacific and its subsidiaries reorganized in a proceeding under 11 U.S.C. § 205, pursuant to a plan approved by the Interstate Commerce Commission and the United States District Court having jurisdiction of the reorganization proceedings. Under the plan, Missouri Pacific issued: (1) Collateral trust notes; (2) first mortgage 4¼ per cent bonds (series B and C); (3) gen-

eral mortgage income 4¾ per cent bonds (series A and B); (4) 5 per cent 90-year debentures; and (5) stock in exchange for its own outstanding debt securities and stock of its subsidiaries; and the subsidiaries were merged into the parent corporation.

The terms of the exchange varied. In some cases, bondholders received new debt securities equal in amount to the sales value of the sum total of their bonds, plus interest accrued and unpaid by Missouri Pacific and its subsidiaries during the process of the reorganization. The accrued interest was deducted by Missouri Pacific from its gross income for federal income taxes in the year it became due. It also took deductions for amortized bond discount, predicated on the fact that the aggregate value of the new bonds issued pursuant to the plan was greater than the value of the securities received in exchange, as shown by New York Stock Exchange price quotations. Missouri Pacific claimed that the aggregate maturity value of the bonds was $529,117,141, while the fair market value of the old securities received in the exchange was $452,151,252, or a difference of $76,965,889, and that such difference in value represented debt discount and was deductible as interest amortized over the life of the new bonds. The court held that Missouri Pacific was not entitled to deduct such discount, because the par value of the old bonds when issued was their "true valuation * * * so far as plaintiff (Missouri Pacific) is concerned." The court held that for the purpose of income tax deduction for bond discount, bonds received in exchange for new bonds are in a completely separate category from other types of property received for the new bonds, and that the value of the old bonds so exchanged should be the amount received therefor by Missouri

Pacific at the time they were issued, rather than their market value at the time of the exchange. In so doing, the court followed its decision in the Lackawanna case, where it held that the preferred stock of the Railroad Company was received by it in exchange for debentures; that the principal amount of the debentures was the same as that received for the preferred stock when issued; and it suffered no loss in the exchange and no discount was allowed.

The two Court of Claims decisions supported the decision of the Tax Court in the instant case, but there is other respectable authority to the contrary. Moreover, the two Court of Claims decisions and the decision in the instant case, as we have heretofore shown, are based on an erroneous premise, namely, that the question is not whether there was a debenture discount which served the purpose of stated interest, but whether there was a loss suffered.

And we regard it as anomalous for the Department of the Treasury to hold in the instant case that National Alfalfa suffered no loss when it exchanged a $50 debenture for a share of preferred stock of the market value of $33, since it had received $50 for such share of preferred stock when it sold it, and to hold that the preferred stockholder realized a gain when he exchanged a share of preferred stock of a market value of $33 for a $50 debenture, when he paid $50 for such share of preferred stock when he purchased it.

It is firmly established by the adjudicated cases that where a corporation issues its bonds, including debenture bonds, which unconditionally oblige the corporation to pay the principal amount stated therein, together with interest thereon, at the times therein provided, and receives therefor the amount of the

principal, less a discount, the amount of such discount is deductible as interest paid and should be amortized over the life of the bonds or debenture bonds.[3]

The reason for allowing the discount is that it represents the expense of borrowing. It serves "the same function as stated interest[4] and "represents a part of the cost of the borrowed capital."[5]

The rationale stated above, with respect to the present treatment of discount as the same as interest paid on borrowed money, was followed and applied in a well considered opinion in American Smelting & Refining Co. v. United States, 3 Cir., 130 F.2d 883. There, bonds were exchanged for preferred stock of a subsidiary of the issuer, when such issuer owned all of the common stock of such subsidiary. The market value of the preferred stock received by the issuer of the bonds was less than the principal of the bonds. The court there rejected the contention made in the instant case, and held that the difference between the sale value of the bonds and the market value of the preferred stock at the time of the exchange represented a discount and was deductible as interest amortized over the life of the bonds.

American Smelting was followed in two subsequent District Court cases in the Fifth and Seventh Circuits, respectively, in Southern Fertilizer & Chemical Co. v. Edwards, U.S.D.C. M.D. Ga., 167 F.Supp. 879 (1955), and Industrial Development Corp. v. United

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[3] Helvering v. Union Pacific Railroad Co., 293 U.S. 282 (1934).

[4] United States v. Midland-Ross Corp., 381 U.S. 54, 57 (1965).

[5] Helvering v. Union Pacific Railroad Co., 293 U.S. 282, 287 (1934).

States, D. Ill., 51 A.F.T.R. 1514, 56-2 U.S.T.C. ¶ 10,066 (1956). Both cases involved the issuance of bonds in exchange for the issuer's preferred stock.*

In Montana Power Company v. United States, 3 Cir., 232 F.2d 541, cert. den. 352 U.S. 843, the court, while disallowing the discount under the facts of that case, at page 546 reaffirmed its decision in the American Smelting case.

The case of Atchison, Topeka and Santa Fe R. Co. v. United States, 10 Cir., 443 F.2d 147 (1971), which was an income tax refund suit, involved the reorganization of the then existing Atchison, Topeka and Santa Fe Railroad Company, hereinafter referred to as the "Old Company." The facts in that case were these:

On December 23, 1893, the Union Trust Company of New York, trustee under the first and second mortgage bonds of the Old Company, filed a complaint in the United States Circuit Court for the District of Kansas, requesting the appointment of a receiver for the properties of the Old Company. Receivers were appointed. On January 1, 1894, the Old Company defaulted in payment of interest on its general mortgage bonds. The Union Trust Company filed a second complaint on March 12, 1894, seeking foreclosure of the mortgage and sale of the railroad's property described in the mortgages. A reorganization took place in 1895, whereby the Atchison, To-

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* See also Nassau Lens Co. v. C.I.R., 2 Cir., 308 F.2d 39, where in answer to the contention of the Commissioner that "when a seller also becomes a financing medium by taking bonds issued at a discount instead of cash in exchange for property, the tax laws will not recognize a charge for the use of money," the court stated: "We find no support for such an assertion and reject it. See American Smelting & Ref. Co. v. United States, 130 F.2d 883 (3rd Cir. 1942)."

peka and Santa Fe Railway Company, hereinafter referred to as the "New Company," the present plaintiff and taxpayer in the action, was organized and acquired all the assets of the Old Company.

After the filing of the first complaint by the Union Trust Company in 1893, bondholder protective committees were quickly formed throughout the country. The stockholders later established the Atchison Protective Reorganization Committee to protect their interests. Following various negotiations, three of the existing bondholder committees created the Joint Executive Reorganization Committee. After arm's length negotiations with the other groups of security holders, the Joint Executive Committee formulated and proposed a plan of reorganization for the Old Company, which was finally approved on April 10, 1895. It proposed the foreclosure of the general mortgage, also referred to as the first mortgage, and the vesting of the properties acquired at the foreclosure sale into the New Company.

Under the plan, the general mortgage bondholders, the second mortgage bondholders, and the income bondholders of the Old Company were to place their respective securities in various depositories and receive in exchange therefor certificates of deposit; and the stockholders of the Old Company were to place their stock in various depositories and receive in exchange therefor certificates of deposit. Under the plan, the holders of the second mortgage bonds, of the income bonds, and of common stock were to pay a cash assessment totaling approximately $14,000,000 into a depository in order to be eligible to receive certificates of deposit and to participate in the plan.

The plan specified what the holders of securities of the Old Company, respectively, would receive in bonds, or bonds and preferred stock, of the New Company in exchange for their certificates of deposit, and what the stockholders of the Old Company should receive in common stock of the New Company in exchange for their certificates of deposit.

On August 27, 1895, the Union Trust Company filed a supplemental complaint in the Circuit Court, requesting that the properties of the Old Company be sold as a single parcel. The Joint Executive Committee was allowed by the court to intervene in the reorganization proceedings, requested the Union Trust Company to go forward with the sale, and the court so ordered. A special master sold the property for $60,000,000 at a public auction on December 10, 1895, to Edward King, President of the Union Trust Company, Victor Marawetz, and Charles Beeman, all representing the Joint Executive Committee. The court approved the sale on the same day, decreeing that the purchasers could transfer the property to a new corporation, subject to certain restrictions, including provision for paying certain general mortgage bondholders of the Old Company who had elected not to participate in the plan.

The next day, December 11, 1895, the property was deeded to the three men. On December 12, 1895, the Joint Executive Committee incorporated the New Company, and the three men deeded the properties to it. The purchase price recited in the deed was $382,202,500, payable as follows: $96,990,500 par value of the New Company's general mortgage bonds; $51,728,000 par value of the New Company's adjustment mortgage bonds; $131,486,000 par value of the New Company's preferred stock; and 1,019,980

shares ($101,998,000 par value) of the New Company's common stock. The New Company delivered these securities and stock to the Joint Executive Committee, which placed them in the Union Trust Company. The Trust Company eventually effected the exchange of the old certificates of deposit for the securities of the New Company.

The basis of the New Company's claim for an income tax refund was that it issued general mortgage and adjustment bonds in exchange for the intangible claims of the general mortgage bondholders of the Old Company; that the fair inherent value of such claims was less than the par value of taxpayer's bonds issued in exchange therefor, and that such difference constituted discount amortizable for federal income tax purposes.

At the trial below, the court ruled that in substance the bonds of the New Company were exchanged for the bonds of the Old Company, and submitted to the jury the questions of whether the fair market value of the bonds received was less than the par value of the bonds paid, and whether such difference constituted amortizable bond discount. The jury found a difference of $56,480,548, and decided that such amount constituted original issue discount.

This court held that the last step in the transaction determined the substance of what had occurred, and that the New Company issued its general mortgage and adjustment bonds in exchange for the intangible claims of the general mortgage bondholders of the Old Company; that the fair inherent value of such claims was less than the par value of the taxpayer's bonds issued in exchange therefor, and that such difference constituted discount amortizable as

interest paid for federal income tax purposes. The court said:

> "Clearly the taxpayer would have been entitled to a deduction for discount had the bonds been sold on the market at a discount, and the proceeds used to purchase the assets of the Old Company."

The court further held that there was no difference in substance between that and what actually happened in the reorganization proceeding, and cited the American Smelter Company case, in which it was said:

> "We believe that the discount is still to be treated as additional interest when the subject matter of the loan is stock instead of cash."

The court further stated:

> "This view conforms with economic and business reality which recognizes that to the issuer bond interest is reflected both by the stated rate of interest and by the amount below or above par received by the issuer when the bonds are originally distributed. The taxpayer in this case presented substantial evidence from experts in railroad securities and properties who relied on the documents surrounding the reorganization, market conditions and actual trading, and valuation of the railroad properties as establishing the economic basis for and probable existence of discount * * *"

and affirmed the judgment of the lower court.

We repeat that we are of the opinion that the decisions of the Tax Court and of the Court of Claims are predicated on an unsound premise when they hold

that whether or not deductions shall be allowed, because of discount as interest paid, depends on whether the taxpayers claiming such deductions suffered a loss in the transactions.

We hold, because it is now settled by the decisions of the Supreme Court, that the deduction is for interest charged by reason of a discount, and not as a loss suffered by the taxpayer.[7]

The decision of the Tax Court sustaining the deficiency assessed by the Commissioner against National Alfalfa for its tax year ending April 30, 1967, and holding that there was a deficiency in income tax due from National Alfalfa for such tax year of $147,949.76 is REVERSED;

And the case is REMANDED, with instructions to direct the Commissioner to allow National Alfalfa to deduct from its gross income for such tax year that portion of the total debenture discount which is deductible as interest paid, amortized, or prorated over the life of the debentures, 18 years, allocable to such tax year ending April 30, 1967; and also to deduct an amount for loss carryovers from prior years, in view of our holding that the debenture discount was

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[7] We are also of the opinion that the case of Claussen's, Inc. v. United States, 5 Cir., —— F.2d ——, (decided November 16, 1972, 41 LW 2278) is clearly distinguishable on the facts from the instant case. In that case, the corporation involved not only issued its bonds in exchange for its outstanding Class A and Class B common stock, but also issued its new common stock to each of its old holders of Class A and Class B common stock, in direct proportion to their original equity interest in the corporation. The court held that the common stockholders' equitable posture relative to the corporation and to one another after the exchange was substantially the same as it was before the exchange, and hence no bond discount arose.

deductible as interest paid, amortized over the life of the debentures, provided National Alfalfa was entitled to take a deduction in its return for its tax year ending April 30, 1967, for losses suffered in prior years, a question not raised nor passed on by this court on this appeal.

No. 72-1125

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY

v.

COMMISSIONER OF INTERNAL REVENUE

HILL, Circuit Judge, dissenting.

I am compelled to respectfully dissent from the majority opinion. My colleagues, in rejecting certain cases, in my opinion have done so on the basis of a rule of law gleaned entirely out of context when viewed with other cases in which this same problem is confronted.

The majority reject Erie Lackawanna Railroad Company v. United States, 422 F.2d 425 (Ct.Cl. 1970), and Missouri Pacific Railroad Company v. United States, 427 F.2d 727 (Ct.Cl. 1970), *modified*, 433 F.2d 1324 (Ct.Cl. 1970), *cert. denied*, 402 U.S. 944, on the basis that those cases "are based on an erroneous premise, namely, that the question is not whether there was a debenture discount which served the purpose of stated interest, but whether there was a loss suffered." I agree with the majority to the extent that loss is not synonymous with discount, but rather that discount "serves 'the same function as

stated interest' and 'represents a part of the cost of the borrowed capital.'" I must conclude, however, the concept of loss as used in those cases is correct when read in context with other cases.

In St. Louis-San Francisco Railway v. United States, 444 F.2d 1102, 1106 (Ct.Cl. 1971), *cert. denied*, 404 U.S. 1017, the court there rejected any discount in either of two exchanges on the basis "that there was an exchange of equals." In analyzing its decision in Erie Lackawanna, the court stated discount was not allowed in that case because "equivalents had been exchanged and no discount could be said to arise." When loss is thus analyzed in the context of whether there was a disparity in values in an exchange, those cases rejected by the majority are clearly authoritative.

A further example of application of this "equivalency of exchange" formula is provided in Cities Service Company v. United States, 316 F.Supp. 61 (S.D. N.Y. 1970). In that case there was a disparity in values in an exchange of debentures for preferred stock due to the higher value of the debentures being offered in exchange. The court there allowed discount measured by the amount of that disparity. That excess represented the true additional consideration which the company was required to pay in retiring its outstanding preferred stock.

The cases cited applying the equivalency of exchange formula have uniformly held that where the corporation is retiring its own outstanding bonds or stock in an exchange transaction, the value to be ascribed those outstanding bonds or stock shares is the value originally received by the corporation in exchange for that outstanding obligation. I am not persuaded that the cases cited in the majority opin-

ion require fair market value to be ascribed the outstanding obligations, as those cases are distinguishable. Both Atchison, Topeka and Santa Fe Railway Co. v. United States, 443 F.2d 147 (10th Cir. 1971), and American Smelting & Refining Co. v. United States, 130 F.2d 883 (3d Cir. 1942), involved corporations exchanging their debt obligations for the outstanding obligations of another corporation. In both cases, the corporation assuming the outstanding obligations was not the corporation which had originally received the consideration for those obligations. This distinction was noted in Erie Lackawanna, supra, and remains viable today, although apparently modified to the extent that the value of outstanding obligations of a subsidiary, when assumed by the parent corporation, is the consideration originally received by the subsidiary rather than the market value of the outstanding obligation.[1] Market value is therefore relevant only when the assuming corporation is other than the corporation which originally issued the obligation.

I would note also that Southern Fertilizer & Chemical Co. v. Edwards, 167 F.Supp. 879 (M.D.Ga. 1955), and Industrial Development Corp. v. United States, 51 A.F.T.R. 1514, 56-2 U.S.T.C. ¶ 10,066 (D.Ill. 1956), on which the majority rely, contain only findings of fact and conclusions of law with no detailed discussion of the question. I therefore, as did the court in Erie Lackawanna, reject those cases as authoritative. I likewise distinguish Montana Power Company v. United States, 232 F.2d 541 (3d Cir. 1955), *cert. denied*, 352 U.S. 843, on the facts, as

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[1] *See* Missouri Pac. R.R. Co. v. United States, 427 F.2d 727 (Ct.Cl. 1970), *modified*, 433 F.2d 1324 (Ct.Cl. 1970), *cert. denied*, 402 U.S. 944.

the issue presented there related to proof of value of property originally exchanged for the corporate obligation. We are here confronted with an exchange of a subsequent corporate obligation for a prior obligation.

My close reading of the cases reveals a formula to be followed when a corporation issues its debt obligation in exchange for its own prior outstanding obligation. In applying this formula, the value assigned the outstanding obligation is the consideration received by the corporation when originally issued. Any discount, therefore, is dependent on a showing of disparity in values reflected by the higher value of corporate debt obligation given in exchange. If there is no disparity in value, that is, if there is an equivalency in the exchange, no discount arises. The facts here clearly show only equivalent exchanges. I would, therefore, affirm the decision of the Tax Court.

APPENDIX C

JANUARY TERM—JANUARY 26, 1973

Before Honorable Orie L. Phillips, Honorable Delmas C. Hill and Honorable William J. Holloway, Jr., Circuit Judges

No. 72-1125

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY, PETITIONER-APPELLANT

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT-APPELLEE

This cause came on to be heard on the record on appeal from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is ordered that the decision of the Tax Court sustaining the deficiency assessed by the Commissioner against National Alfalfa for its tax year ending April 30, 1967, and holding that there was a deficiency in income tax due from National Alfalfa for such tax year of $147,949.76 is reversed and the case is remanded, with instructions to direct the Commissioner to allow National Alfalfa to deduct from its gross income for such tax year that portion of the total debenture discount which is deductible as interest paid, amortized, or prorated over the life of the debentures, 18 years, allocable to such tax year ending April 30, 1967, and also to deduct an amount for loss carryovers from prior years, in view of our holding that the deben-

ture discount was deductible as interest paid, amortized over the life of the debentures, provided National Alfalfa was entitled to take a deduction in its return for its tax year ending April 30, 1967, for losses suffered in prior years, a question not raised nor passed on by this court on this appeal. Hill, Circuit Judge, dissenting.

A true copy

Teste

HOWARD K. PHILLIPS
Clerk

By: /s/ Lavon M. Irlbeck
LAVON M. IRLBECK
Deputy Clerk

APPENDIX D

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 163. INTEREST.

(a) *General Rule.*—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

* * * *

SEC. 1232. BONDS AND OTHER EVIDENCES OF INDEBTEDNESS.

* * * *

(b) *Definitions.*—

(1) *Original issue discount.* — For purposes of subsection (a), the term "original issue discount" means the difference between the issue price and the stated redemption price at maturity. If the original issue discount is less than one-fourth of 1 percent of the redemption price at maturity multiplied by the number of complete years to maturity, then the issue discount shall be considered to be zero. For purposes of this paragraph, the term "stated redemption price at maturity" means the amount fixed by the last modification of the purchase agreement and includes dividends payable at that time.

(2) [as amended by Sec. 5, Interest Equalization Tax Act, P.L. 88-563, 78 Stat. 809, and Sec. 413(b), Tax Reform Act of 1969, P.L. 91-172, 83 Stat. 487] *Issue price.*—In the case of issues of bonds or other evidences of indebtedness registered

with the Securities and Exchange Commission, the term "issue price" means the initial offering price to the public (excluding bond houses and brokers) at which price a substantial amount of such bonds or other evidences of indebtedness were sold. In the case of privately placed issues of bonds or other evidence of indebtedness, the issue price of each such bond or other evidence of indebtedness is the price paid by the first buyer of such bond increased by the amount, if any, of tax paid under section 4911 (and not credited, refunded, or reimbursed) on the acquisition of such bond or evidence of indebtedness by the first buyer. For purposes of this paragraph, the terms "initial offering price" and "price paid by the first buyer" include the aggregate payments made by the purchaser under the purchase agreement, including modifications thereof. In the case of a bond or other evidence of indebtedness and an option or other security issued together as an investment unit, the issue price for such investment unit shall be determined in accordance with the rules stated in this paragraph. Such issue price attributable to each element of the investment unit shall be that portion thereof which the fair market value of such element bears to the total fair market value of all the elements in the investment unit. The issue price of the bond or other evidence of indebtedness included in such investment unit shall be the portion so allocated to it. In the case of a bond or other evidence of

indebtedness, or an investment unit as described in this paragraph (other than a bond or other evidence of indebtedness or an investment unit issued pursuant to a plan of reorganization within the meaning of section 368(a)(1) or an insolvency reorganization within the meaning of section 371, 373, or 374), which is issued for property and which—

(A) is part of an issue a portion of which is traded on an established securities market, or

(B) is issued for stock or securities which are traded on an established securities market,

the issue price of such bond or other evidence of indebtedness or investment unit, as the case may be, shall be the fair market value of such property. Except in cases to which the preceding sentence applies, the issue price of a bond or other evidence of indebtedness (whether or not issued as a part of an investment unit) which is issued for property (other than money) shall be the stated redemption price at maturity.

* * * *

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§ 1.61-12 [as republished in T.D. 6500, 25 Fed. Reg., Part 11, pp. 11402, 11442-11443] *Income from discharge of indebtedness.*

* * * *

(c) *Sale and purchase by corporation of its bonds.* * * *

* * * *

(3) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. If the corporation purchases any of such bonds at a price in excess of the issuing price plus any amount of discount already deducted, the excess of the purchase price over the issuing price plus any amount of discount already deducted (or over the face value minus any amount of discount not yet deducted) is a deductible expense for the taxable year. If, however, the corporation purchases any of such bonds at a price less than the issuing price plus any amount of discount already deducted, the excess of the issuing price, plus any amount of discount already deducted (or of the face value minus any amount of discount not yet deducted), over the purchase price is income for the taxable year.

* * * *

§ 1.163-3 [as amended by T.D. 6984, 1969-1 Cum. Bull. 38] *Deduction for bond discount.*

(a) *Discount upon issuance.* (1) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. For purposes of this section, the amortizable bond discount equals the excess of the amount payable at maturity (or, in the case of a callable bond, at the earlier call date) over the issue price of the bond (as defined in paragraph (b)(2) of § 1.1232-3).

* * * *

Examples. The rules in paragraph (a) of this section are illustrated by the following examples:

Example (1). M Corporation, on January 1, 1960, the beginning of its taxable year, issued for $95,000, 3 percent bonds, maturing 10 years from the date of issue, with a stated redemption price at maturity of $100,000. M Corporation should treat $5,000 ($100,000-$95,000) as the total amount to be amortized over the life of the bonds.

* * * *

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SUPREME COURT, U. S.

In the Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-9

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

VS.

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY,
Respondent.

BRIEF OF RESPONDENT IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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In the Supreme Court of the United States

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Petitioner,

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NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY,
Respondent.

BRIEF OF RESPONDENT IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

QUESTION PRESENTED

Respondent believes that petitioner's characterization of the question presented is superficial and does not accurately express the real issue in the case. The question accurately stated is whether respondent incurred amortizable original issue bond discount in issuing its $50 face amount, 18-year, 5% sinking fund debentures to its preferred stockholders in a one for one exchange for their preferred stock in respondent when at the time of the exchange in 1957 the fair market value of the preferred stock was $33 per share.

STATEMENT OF THE CASE

Petitioner's statement of the case de-emphasizes, at the expense of accuracy, the clear distinctions between the debentures and the preferred stock involved in the exchange, and consequently the true nature of the transaction which the Court of Appeals for the Tenth Circuit properly concluded created deductible bond discount.

On July 23, 1957, the preferred stockholders of respondent exchanged their preferred stock for respondent's $50 face amount, 18-year, 5% sinking fund debentures due in 1975. At the time of the exchange the fair market value of the preferred stock was $33 per share, a fact agreed upon by the parties in the Tax Court. The transaction was treated as a taxable exchange by the preferred stockholders as required by the United States Treasury Department in a ruling letter issued prior to the exchange which required the fair market value of the stock and the debentures to be used in determining the reportable amount of gain and loss to those stockholders. (Appendix B, p. 48).[1] Because the fair market value of the stock and debentures at the time of the exchange was relevant to petitioner for computing taxable gain and loss to the stockholders in 1957, respondent maintained that the fair market value ($33) also controlled the issue price of respondent's debentures and the amount of bond discount incurred.

The terms of the debentures appear in the debentures and in an Indenture dated July 1, 1957 between respondent and Fidelity-Philadelphia Trust Company, the Trustee under the Indenture. The debentures, as contrasted with

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1. All references to Appendices herein cited are references to Appendices found in petitioner's Petition for Writ of Certiorari.

the preferred stock, created a fixed obligation on the part of respondent to unconditionally pay interest of 5% and repay the principal at a fixed time in the future, regardless of the profits of respondent. Such a fixed obligation never existed prior to the exchange. (Appendix B, *supra* n.1, pp. 49-50).

A sinking fund was established pursuant to the Indenture in order to assure retirement of the debentures. Respondent was at all times on schedule in meeting the requirements of the sinking fund and never defaulted on any of the terms of the Indenture. (Appendix B, *supra* n.1, pp. 49-50). Since the commencement of this case, respondent has redeemed and retired all of the debentures, and consequently, no further deduction for the bond discount at issue in this case is being taken at this time nor will be taken in the future.

The preferred stock received by respondent, in exchange for the debentures, was retired and cancelled, upon the issuance of the debentures, by an entry on respondent's books debiting the capital account for preferred stock (a stockholders' equity account) and crediting the liability account for 18-year, 5% debentures (a long-term liability account). (Appendix B, *supra* n.1, p. 43). This accounting for the transaction reflected the very basic transformation which occurred in the capital structure of respondent. The debentureholder, a creditor, replaced the preferred stockholder, an owner. The unconditional obligation to pay the principal amount of the debentures at maturity plus the stated annual interest replaced the discretionary power in the respondent relative to dividend payments on the stock which depended upon the earnings of respondent. (Appendix B, *supra* n.1, pp. 43-44).

The financial status of respondent at the time of the exchange and the circumstances surrounding the issuance

of the debentures were typical of the circumstances which compel any corporation to issue debt securities at a discount. The 1957 exchange was, in fact, a transaction demanded by economic and business reality. The preferred stock in the market place was worth $33 a share. There were two years of dividend arrearages outstanding on the preferred stock. Further, respondent's operations, as reflected in its income statements, and its financial status, as reflected in its balance sheets, were in critically poor condition. (Appendix B, *supra* n.1, p. 43).

When respondent issued its debentures for the preferred stock, the amount received for the debentures, from its standpoint, clearly was the $33 market value of the preferred stock. The value of the preferred stock on the open market at the time of the exchange ($33) clearly determined the face amount and interest rate of the debentures which respondent was willing to issue and the preferred stockholders were willing to accept.

ARGUMENT

Respondent believes that petitioner has wholly failed to establish any grounds upon which review of this case by the Supreme Court of the United States is justified.

1. The Court of Appeals for the Tenth Circuit in reversing the United States Tax Court rendered an exhaustive opinion in which it directly pointed out that the Supreme Court had previously decided the basic and narrow issue involved in this case, and that consequently there was a lack of conflict among the courts. In noting this the court stated as follows:

> "It is firmly established by the adjudicated cases that where a corporation issues its bonds, including debenture bonds, which unconditionally oblige the corporation to pay the principal amount stated therein, together with interest thereon, at the times therein provided, and received therefor the amount of the principal, less a discount, the amount of such discount is deductible as interest paid and should be amortized over the life of the bonds or debenture bonds.[3] [3. *Helvering* v. *Union Pacific Railroad Co.*, 293 U.S. 282 (1934)].
>
> "The reason for allowing the discount is that it represents the expense of borrowing. It serves 'the same function as stated interest'[4] [4. *United States* v. *Midland-Ross Corp.*, 381 U.S. 54, 57 (1965)] and 'represents a part of the cost of the borrowed capital.'[5] [5. *Helvering* v. *Union Pacific Railroad Co.*, 293 U.S. 282, 287 (1934)].
>
> * * *

"We hold, because it is now settled by the decisions of the Supreme Court, that the deduction is for interest charged by reason of a discount * * *." (Appendix B, *supra* n.1, 58, 59, 65).

These basic principles of the tax law, establishing the deductibility of bond discount as interest as pronounced by the Supreme Court, have been followed by the various courts of appeal without exception for many years.

The Petition for Certiorari wholly fails to point out the applicability of any principle of the tax law which dictates a method for determining whether bond discount exists in any given situation other than the basic rules set forth in the foregoing decisions of the Supreme Court. *United States* v. *Midland-Ross Corp., supra; Helvering* v. *Union Pacific Railroad Co., supra.*

Nevertheless, petitioner, in relying upon the decisions and analysis of the Court of Claims in certain bond discount cases arising out of railroad reorganizations, seems to be suggesting to the contrary and that a determination as to whether or not bond discount exists in a given case can be made without regard to the economic facts surrounding the particular exchange transaction being analyzed. This contention is directly in conflict with the Supreme Court's stated views. Bond discount, as such, is not defined in the Internal Revenue Code nor the Treasury Regulations, and therefore whether it exists or not, as the result of a certain transaction, cannot be determined as a matter of law. Bond discount is a creature of economic fact as clearly recognized by those cases decided by the Supreme Court.

Respondent believes that petitioner's claim that the court of appeals' decision in this case is in conflict with the decisions of other courts is clearly an overstatement.

The cases cited in the Petition, other than those decided by the Court of Claims, clearly reflect unanimity. If the Court of Claims cases are isolated from the remaining body of law on the issues here involved, it is clear that only factual distinctions among the remaining cases, based on the economic facts of the individual transactions analyzed, have caused the numerous remaining decisions to vary to any extent.

Those Court of Claims cases relied upon by petitioner stand alone in their views against a formidable array of cases of the Supreme Court (*United States* v. *Midland-Ross Corp., supra; Helvering* v. *Union Pacific Railroad Co., supra*) and cases from various circuits which uphold in every respect the authoritative and well-reasoned decision of the Court of Appeals for the Tenth Circuit in this case. *Atchison, Topeka and Santa Fe R.R. Co.* v. *United States,* 443 F.2d 147 (10th Cir. 1971); *Nassau Lens Co.* v. *Commissioner,* 308 F.2d 39 (2d Cir. 1962); *Montana Power Co.* v. *United States,* 232 F.2d 541 (3d Cir. 1956); *American Smelting & Refining Co.* v. *United States,* 130 F.2d 883 (3d Cir. 1942); *Southern Fertilizer & Chemical Co.* v. *Edwards,* 167 F. Supp. 879 (M.D. Ga. 1955); and *Industrial Development Corp.* v. *United States,* 56-2 U.S.T.C. ¶10066 (N.D. Ill. 1956).

The Court of Claims' decisions actually conflicting with the decision of the Court of Appeals for the Tenth Circuit in this case are *St. Louis-San Francisco Railway Co.* v. *United States,* 444 F.2d 1102 (Ct. Cl. 1971), *cert. denied* 404 U.S. 1017 (1972); *Missouri Pacific R.R. Co.* v. *United States,* 433 F.2d 1324 (Ct. Cl. 1970), *cert. denied* 402 U.S. 944 (1971); and *Erie Lackawanna R.R. Co.* v. *United States,* 422 F.2d 425 (Ct. Cl. 1970), the former relying on the latter as the basis for their decisions. Although *Texstar Corp.* v. *United States,* 73-1 U.S.T.C. ¶9105 (N.D. Tex. 1972) is mentioned in the Petition as a potentially con-

flicting decision, its value as authority on the issues here is of relatively little significance in view of the fact that whether or not discount existed was left to a jury by the district court.

Claussen's Inc. v. *United States,* 469 F.2d 340 (5th Cir. 1972), another purportedly conflicting decision, was clearly and appropriately distinguished by the Court of Appeals for the Tenth Circuit in its decision, based again on the economic facts of the transaction there involved. The Court of Appeals for the Tenth Circuit stated in its opinion:

> "We are also of the opinion that the case of *Claussen's Inc.* v. *United States,* 5 Cir., 469 F.2d 340 (decided November 16, 1972) is clearly distinguishable on the facts from the instant case. In that case, the corporation involved not only issued its bonds in exchange for its outstanding Class A and Class B common stock, but also issued its new common stock to each of its old holders of Class A and Class B common stock, in direct proportion to their original equity interest in the corporation. The court held that the common stockholders' equitable posture relative to the corporation and to one another after the exchange was substantially the same as it was before the exchange, and hence no bond discount arose." (Appendix B, *supra* n.1, p. 65 n.7)

Petitioner has also cited, in footnote 1 on page 6 of the Petition, *Cities Service Co.* v. *United States,* 316 F. Supp. 61 (S.D.N.Y. 1970), *reaffirmed,* 330 F. Supp. 421 (S.D.N.Y. 1971) as a conflicting decision. After the decision in the present case was rendered by the Court of Appeals for the Tenth Circuit, a District Court for New York rendered its decision on the merits in that same case, *Cities Service Co.* v. *United States,* 73-2 U.S.T.C. ¶9495 (S.D.N.Y. June 12, 1973), referring to the decision of the Court of Appeals for

the Tenth Circuit in the case at hand. The district court in the latest *Cities Service* decision chose to look to the economic facts surrounding the similar exchange which took place in that case as the appropriate method to be used in determining the existence and amount of bond discount.

An analysis of the *Erie Lackawanna* case, *supra*, which is the basic conflicting decision cited by the petitioner, indicates it to be clearly erroneous because it is not based on sound reasoning and because it departs completely from the prior decisions of the Supreme Court in that it ignores the economic facts surrounding the exchange transaction which took place in that case.

As stated by Judge Phillips in the Court of Appeals for the Tenth Circuit's opinion in the case at hand:

> "* * * [T]he Court of Claims decisions [*Erie* and *Missouri Pacific*] * * * are based on an erroneous premise, namely, that the question is not whether there was a debenture discount which served the purpose of stated interest, but whether there was a loss suffered." (Appendix B, *supra* n.1, p. 58)

The essence of Judge Phillips' criticism of the decision in the *Erie* case was that it does not conform to economic and business realities. Economic and business realities dictate that the value in the open market of the preferred stock or old bonds or the like, at the time of an exchange, determines the face amount and interest rate of the debentures which the issuing corporation is willing to issue and the preferred stockholders or old bondholders are willing to accept. If the shoe were on the other foot and the fair market value of the preferred stock was greater, at the time of the proposed exchange, than the proposed face amount of the new debentures, economic and

business realities would likewise have dictated that the preferred stockholders refuse to accept the new debentures in the exchange.

Respondent believes that the decisions of the Supreme Court herein cited and the decisions of the various courts of appeal clearly recognize and stand for the proposition that economic reality necessarily must govern in determining whether bond discount exists in any given case and the amount thereof.

2. Respondent seriously questions the petitioner's claim as to the great administrative importance of the question here involved. The question is very narrow in its scope and far more readily lends itself to congressional legislative action, than it does to resolution by the courts. In this respect, respondent believes that Congress has reviewed the matter recently and has chosen to stand by the previous decisions of the Supreme Court and courts of appeal. If the administrative importance of potential bond discount cases were as great as is now suggested by petitioner, Congress surely would have been aware of it when it thoroughly considered the law, on the subject matter here involved, in the Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487 (1969).

In the Tax Reform Act of 1969, Congress amended section 1232(b) (2) of the Internal Revenue Code, dealing with the treatment of original issue discount by bondholders. The primary purpose and effect of the amendment was to achieve consistency in treatment between bond issuers and holders in the reporting of discount: holders were required to report discount income ratably over the life of the bond, just as issuers had always ratably amortized discount expense. A secondary purpose was to more clearly define those situations in which bond discount might arise.

The 1969 changes arose at the instance of the Treasury, which made the following proposal:

> "Present concern is also expressed about transactions in which debt is a significant element of the acquisition price. Tax policy should focus on the appropriateness of the interest deduction with respect to the issued debt. It appears, however, that the greatly increased use of debt in recent acquisitions, is motivated primarily by factors other than the desire to obtain an interest deduction for tax purposes. * * *
>
> * * *
>
> "In addition, we propose that the following immediate steps be taken by legislative action. These steps will impede mergers and acquisitions in which debt securities are used to gain tax advantages. * * *
>
> "(2) To achieve consistency of treatment between bondholders and the issuing company where bonds are issued at a discount, we recommend that Section 1232 be amended to require that original issue discount be treated as additional interest income to the bondholders to be reported ratably over the life of the bonds." Representatives of the Treasury Department, Tax Reform Proposals Contained in the Message from the President of April 21, 1969, Presented to the Comm. on Ways and Means, 91st Cong., 1st Sess. 46-49 (Comm. print 1969).

The Treasury recognized that a corporation could amortize and deduct discount with respect to bonds issued for stock or securities or other assets. The Treasury did not propose to alter that treatment. It only proposed that the bondholders' treatment be made consistent.

As passed by the House and as reported by the Senate Finance Committee, section 413 of the Act contained the following addition to section 1232(b) (2) of the Code:

> "In the case of a bond or other evidence of indebtedness, or an investment unit as described in this paragraph, issued for property, the issue price of such bond or other evidence of indebtedness or investment unit, as the case may be, shall be the fair market value of such property."

In explaining this provision, the House Ways and Means Committee observed:

> "There is some question under present law as to whether the original issue discount rule applies to a bond which is issued for property, such as stock, which has a value below the face amount of the bond.
>
> * * *
>
> "In order to clarify the situations in which original issue discount may arise, the bill further provides that there may be original issue discount when a corporation issues a bond for a price less than its face value whether it receives cash, stock, or other property (including the assets of another corporation) for the bond." H.R. Rep. No. 91-413 (Pt. 1), 91st Cong., 1st Sess. 109-110 (1969).

The clarification presumably intended was to provide expressly what the Treasury and the Ways and Means Committee assumed was the sound existing law—that the issuing corporation could deduct and amortize bond discount on bonds issued for stock or securities.[2] It was also

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2. A clarification of existing law by a Committee report is entitled to great respect. Cf. *Commissioner* v. *Bilder*, 369 U.S. 499 (1962).

intended to make the debentureholders' treatment of original issue discount consistent with that of the issuer.

The Senate Finance Committee, after considering the proposed changes, approved the House proposal to clarify the situation in which original issue discount may arise when bonds or evidence of indebtedness are issued for property. S. Rep. No. 91-522, 91st Cong., 1st Sess. 146-148 (1969). The Staff of the Joint Congressional Committee noted that "[t]he bill also clarifies present law by providing that original issue discount may arise when a bond is issued in exchange for stock or other property." Staffs of Joint Comm. on Internal Revenue Taxation & Comm. of Finance, 91st Cong., 1st Sess., Summary of H.R. 13270, The Tax Reform Act of 1969 (As Passed by the House of Representatives) 61 (Comm. Print 1969).

At the last-minute suggestion of the Treasury, the Bill was modified on the floor of the Senate in two respects: (1) the issue price determined on the basis of the fair market value of the property was limited to situations where either the bonds are traded on an established securities market or the property consists of securities so traded; (2) the definition of issue price was revised so that in the case of a bond or evidence of indebtedness issued pursuant to a plan of reorganization, the issue price would be the stated redemption price at maturity. Parenthetically, this latter provision, which was enacted into law, refers to tax free reorganizations as distinguished from the taxable transaction involved in the case at hand.

In two major respects the legislation discussed above and the Congressional action thereon renders action by the Supreme Court in this case unnecessary on what appears now to be a moot issue. First, Congress has within just four years reviewed in depth the law in this area and has found no necessity for changes other than those then made

which now appear in the law. This recent legislation and the history behind it gives strong support to the decision of the Court of Appeals for the Tenth Circuit in this case which decision conforms to the previous decisions of the Supreme Court and other courts of appeal.

Secondly, with respect to issues of debentures by taxpayers after May 27, 1969, the issues presented in the instant Petition have been disposed of by Congressional action and the questions are moot, a fact recognized by petitioner in the Petition where it is noted that section 1232(b)(2) as amended applies to bonds or evidences of indebtedness issued after May 27, 1969.

The petitioner's additional assertion in the Petition that the Supreme Court should grant certiorari in this case solely because the Internal Revenue Service anticipates a variety of bond discount problems, which are yet undefined, indicates that petitioner may be premature in its request to the Court. Even when these problems mature the cases will have to be decided on the basis of the same principle heretofore pronounced by the Supreme Court, said principle being that the economic facts surrounding an exchange transaction will control in the determination of whether or not bond discount arises. This is the only possible principle which can be developed because bond discount is a creature of economic fact.

CONCLUSION

The Petition for Certiorari should not be granted because the decision of the Court of Appeals for the Tenth Circuit is not in conflict with any decision of this Court or the decisions of the other courts of appeal on the issues presented by the Petition, and the Court of Appeals for the

Tenth Circuit has decided the issues raised entirely in accordance with applicable decisions of this Court and in harmony with well-reasoned decisions of all other courts which have rendered decisions on the issues herein raised.

Respectfully submitted,

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I certify that on the 16th day of August, 1973, a copy of the above and foregoing Brief of Respondent in Opposition to Petition for Writ of Certiorari was sent postage prepaid, by regular United States mail, to the Honorable Robert H. Bork, Solicitor General, Department of Justice, Washington, D.C. 20530, Scott P. Crampton, Assistant Attorney General, Department of Justice, Washington, D.C. 20530, and Meyer Rothwacks and Ernest J. Brown, Attorneys, Department of Justice, Washington, D.C. 20530.

Attorney for Respondent

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In the Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-9

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the Tax Court (Pet. App. A 18–41)[1] is reported at 57 T.C. 46. The opinion of the court of appeals (Pet. App. B 42–69) is reported at 472 F.2d 796.

JURISDICTION

The judgment of the court of appeals (Pet. App. C 70–71) was entered on January 26, 1973. On April 18, 1973, Mr. Justice White extended the time for filing a

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[1] "Pet. App." references are to the appendices to the petition for certiorari.

petition for a writ of certiorari to and including June 25, 1973, and the petition was filed on that date. The petition was granted on October 9, 1973 (R. 224).[2] This Court's jurisdiction rests on 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether respondent's recapitalization through the issuance of 5 percent debentures in the face amount of $50 for each share of outstanding $50 par 5 percent cumulative preferred stock gave rise to a $17 deduction for amortizable bond discount for each debenture issued, reflecting the difference between the face amount of the debentures and the market value ($33 per share) of the eliminated preferred stock.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Sections 163 and 1232 of the Internal Revenue Code of 1954, and of Treasury Regulations on Income Tax (1954 Code), §§ 1.61–12 (as effective in 1957) and 1.163–3 (effective since 1968) are set forth in the Appendix, *infra*, pp. 37–40.

STATEMENT

In July 1957, in addition to an issue of $1 par common stock, respondent had outstanding 47,059 shares of $50 par, 5% cumulative preferred stock, on which there were dividend arrearages of $10 per share (R. 25). These preferred shares were normally redeemable in whole or in part at the discretion of the board of directors, or through the operation of a sink-

[2] "R." references are to the separately bound record appendix.

ing fund,[3] at a price which was, in 1957, $51 per share plus accrued dividends. Any preferred shares redeemed could not be reissued, but had to be cancelled or retired (R. 192, 196). When, however, there were dividend arrearages on the preferred shares, there were restrictions upon the acquisition and retirement of such stock in transactions with individual shareholders.[4] Upon voluntary liquidation of the corporation, holders of the preferred shares were entitled to $50 per share, plus accrued dividends, prior to any distribution to common shareholders (R. 196).

On April 8, 1957, respondent's board of directors adopted resolutions which proposed "a reorganization of the Company by way of recapitalization." The board proposed a three-step plan. First, an amendment of the certificate of incorporation to (a) eliminate the preferred shares as of August 1, 1957; (b) increase the par value of the common shares from $1 to $3 and increase their authorized number from 763,000 to 1,000,000; and (c) authorize the issuance of warrants for the purchase of common stock. Second,

[3] The sinking fund provisions (R. 193–196), operative after September 1, 1948, required that 20 percent of consolidated net earnings (after the payment of dividends on the preferred shares then outstanding) should be set aside and employed for the redemption of preferred shares as long as there were any preferred shares outstanding.

[4] Preferred shares could not be purchased, redeemed, or otherwise acquired for value at any time while there were dividend arrearages thereon unless the holders of 50 percent of the preferred shares consented, or unless the corporation notified all preferred shareholders of its desire to purchase such preferred shares and invited tender offers (R. 199, 201).

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the plan called for the issuance under an indenture of 5% debentures due July 1, 1975 in the principal amount of $2,352,950. The holder of each share of the $50 par 5% cumulative preferred stock to be eliminated would receive one of the newly-issued debentures in the face amount of $50. Third, the board proposed the issuance to the preferred shareholders of a warrant to purchase one-half of a share of common stock at the price of $10 per share in lieu of the dividend arrearages (R. 25, 53, 56–59).

Following stockholder approval of all three aspects of the plan at the annual meeting,[5] the outstanding cumulative preferred stock was eliminated and cancelled as of August 1, 1957. The holder of each share of the eliminated $50 par 5% cumulative preferred stock received a 5% debenture in the face amount of $50 payable July 1, 1975. Each received also a warrant to

[5] A proxy statement (R. 173, 176–181) which accompanied the notice of the proposals to the shareholders (R. 172) explained them in greater detail, and summarized the principal provisions of the indenture under which the debentures were to be issued, including provisions for subordination, redemption, and a sinking fund.

Specifically, the debentures were to be subordinate to bank loans for inventory purposes and to obligations to suppliers of materials, services and labor in the normal course of business (R. 100). They were redeemable in whole or in part, and from time to time, after July 1, 1958, at par, plus accrued interest to date of redemption (R. 97–100). The sinking fund provision required respondent, after April 30, 1959, to set aside annually, for redemption of debentures at par plus accrued interest, the lesser of either the sum sufficient to redeem $196,080 face amount of debentures or 100% of the consolidated net earnings for the fiscal year, with the proviso that if the latter alternative were applicable for any year the fixed figure should be deemed cumulative (R. 100–102).

subscribe to one-half share of common stock at a price of $10 per share in lieu of dividend arrearages (R. 25, 172). Respondent's books reflected this transaction by debiting the preferred stock account for the $2,352,950 par amount eliminated and crediting the liability account for 18-year 5% debentures with $2,352,950 (R. 26. 157–158).

During the latter half of July 1957, bid prices for respondent's preferred stock ranged from a low of 29 to a high of 33, and offering prices ranged from a low of 32 to a high of 35 (R. 27, 161, 163–167). On its income tax returns for fiscal years ended April 30, 1958 through 1967, respondent claimed deductions for bond discount asserted to have been created upon the issuance of its $50 debentures. The alleged discount was measured by the differences between the asserted market value of $33 for each share of the eliminated preferred stock and the $50 face amount of each debenture issued in lieu of a share of the preferred stock. The deductions in earlier years were included in losses carried over to fiscal 1967. The Commissioner of Internal Revenue disallowed a deduction of $109,804 for bond discount for 1967, and $321,657 of claimed loss carryovers from prior years by virtue of deductions for bond discount claimed in those years, and asserted a deficiency for 1967 (R. 13–16, 27–28).

The Tax Court, in a unanimous reviewed decision, upheld the deficiency asserted by the Commissioner. The Tax Court's opinion adopted the reasoning of recent decisions of the Court of Claims which have held that when a corporation issues its obligations for or in lieu of its own previously outstanding preferred

stock or bonds, no discount can arise upon the issuance of the obligations if the amount received upon the issuance of the original securities was equal to the face amount of the obligations issued in exchange. Under those circumstances, the Court of Claims deemed irrelevant the market value of the original securities at the time of the exchange (Pet. App. A 18, 27–41). The court of appeals reversed, with one judge dissenting. It held that the issuance of each $50 debenture gave rise to $17 of discount, represented by the difference between the $50 face amount of the debenture and the market value ($33 per share) of the preferred stock (Pet. App. B 42–69).

SUMMARY OF ARGUMENT

A

If a corporation issues a ten-year bond in the face amount of $1,000 for $950, the $50 difference is an additional cost of borrowing known as discount, which is deductible in the amount of $5 per year over the term of the bond. Although the Internal Revenue Code and its predecessor Revenue Acts have never explicitly provided for a deduction for bond discount, the Treasury Regulations since 1918 have authorized amortization and deduction of bond discount, where it exists, over the term of the bond. The early Regulations referred to discount as loss, and this Court's early decisions referred to discount both as loss and as interest, without distinction. More recently, however, the Court has been explicit in recognizing discount as serving the function of interest, and the current

Regulations treat it under Section 163, which allows a deduction for interest paid or accrued.

The question in this case is whether respondent became entitled to deductions for bond discount upon the issuance of 5% debentures in the face amount of $50 in substitution for its previously outstanding shares of $50 par, 5% preferred stock. Contrary to decisions of the Court of Claims, the court of appeals found discount equal to the difference between the face amount of the debenture ($50) and the market price of the preferred stock ($33) as of its retirement. In identical transactions, the Court of Claims has explicitly held that the market value of the preferred stock is irrelevant.

In order for discount to exist, there must be an outlay, or an obligation to make an outlay, in excess of the amount of borrowed capital. Here there was neither the requisite outlay nor the obligation. All that occurred was a simple capital readjustment in the form of a recapitalization with no obligation to pay out more than the capital received. Under these circumstances, there was no basis for the existence of discount.

Moreover, if the stock were retired for cash, no deduction woud be available either for the par value of the stock for any call or redemption premium, or because the stock was retired for a greater amount than the issue price. The substitution of an interest-bearing obligation in the face amount of the cash that otherwise would have been paid should not produce a deduction for discount.

B

The decision of the court below rests upon two erroneous analogies. First, the court assimilated the transaction to one where bonds are issued for property. The question whether discount arises when bonds are issued for property has been the subject of some judicial disagreement, although it has been settled legislatively for years after 1969. However, because the retirement of stock is not the acquisition of property, the analogy is inapposite. There is consequently no need to reach the bonds-for-property question in the resolution of this case.

Secondly, the court below assimilated the transaction to one where respondent issued $50 face amount bonds for $33 and thereafter used the cash to retire the preferred stock. But such an analysis is directly contrary to a decision of this Court, and its progeny in the lower courts, that the substitution of one issue of securities for another is a continuation of corporate capitalization in altered form. There is accordingly no basis for the court of appeals' division of respondent's unified recapitalization into hypothetical non-existent components.

C

On the facts of this case, it is arithmetically apparent that no discount could arise from the issuance of a $50 debenture in substitution for preferred stock for which $50 has been paid in to the corporation. This arithmetical equivalence is the basis of the decisions of the Court of Claims, which the Tax Court followed in this case. The results of those cases are undeniably sound and approval of their reasoning by

this Court would be sufficient to reverse the judgment below.

Although we subscribe to the results reached in those cases, we believe that in some of its opinions, the Court of Claims has erroneously indicated that discount would arise in the case where preferred stock was issued for less than the face amount of the bond. It does not and should not follow that discount would arise had the preferred stock been issued for less than the face amount of the bond. The many reasons and occasions for the retirement of corporate stock in an amount greater than the issue price are unrelated to compensation for the use or forbearance of money, which this Court has identified as the function of discount. Because of the misconceptions in that aspect of the decisions of the Court of Claims, we do not urge this Court to approve their reasoning. Instead, we have sought reversal here on the broader ground that the substitution of one security for another does not produce deductible bond discount. At all events, the decision below cannot stand.

ARGUMENT

RESPONDENT'S SUBSTITUTION OF ITS 5% DEBENTURES IN THE FACE AMOUNT OF $50 FOR ITS PREVIOUSLY OUTSTANDING $50 PAR, 5% PREFERRED STOCK DID NOT GIVE RISE TO DEDUCTIBLE BOND DISCOUNT

A. INTRODUCTION: THE NATURE OF BOND DISCOUNT

1. Section 163(a) of the Internal Revenue Code, Appendix, *infra*, p. 37, allows a deduction for "all interest paid or accrued within the taxable year on indebtedness." In *Deputy* v. *duPont*, 308 U.S. 488, 498, this Court construed the term "interest on indebt-

edness" to mean "compensation for the use or forbearance of money."

Simply put, bond discount is a form of interest on indebtedness which, although unstated, is in economic terms additional compensation to the bondholder for the use of his money. The prototype transaction where discount arises is one where a corporation receives $950 upon the issuance of its bond in the face amount of $1,000, payable 10 years after issuance. While the bond may have a stated annual interest rate of 5% so that the holder receives $50 per year, the $50 difference between the issue price ($950) and the face amount ($1,000) represents an additional cost to the corporation for the use of the money of $5 per year over the ten-year life of the bond. Accepted accounting practice treats discount as deferred interest.[6]

The Internal Revenue Code and its predecessor Revenue Acts have never explicitly provided for the amortization and deduction of bond discount. However, Article 150 of Treasury Regulations 33 (1918 ed.), relating to the 1916 Revenue Act, and all subsequent Treasury Regulations under the income tax statutes have provided for such amortization and deduction by the issuer of bonds at a discount.[7] Under the 1954 Code, the relevant provision first appeared under the definition of gross income as Treasury Regulations on Income Tax, § 1.61–12(c)(3), Appen-

[6] See, *e.g.*, Finney and Miller, *Principles of Accounting, Intermediate* (6th ed. 1965), p. 263.

[7] The history of the earlier Regulations is set forth in *Montana Power Co.* v. *United States*, 232 F. 2d 541, 546–548 (C.A. 3), certiorari denied, 352 U.S. 843.

dix, *infra,* p. 39. It states: "If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds." Since 1968, this Regulation has appeared under the interest deduction provision as § 1.163–3(a)(1), Appendix, *infra,* p. 40.

The first statutory definition of bond discount appeared as Section 1232(b)(1) of the 1954 Code, Appendix, *infra,* p. 37. It provides that "For purposes of subsection (a), the term 'original issue discount' means the difference between the issue price and the stated redemption price at maturity." Section 1232(b)(2), Appendix, *infra,* pp. 37–39, also first introduced as part of the 1954 Code, defines the term "issue price."[8] As a result of the position taken by these longstanding Treasury Regulations, it is clear that the corporation in the prototype transaction described above would be permitted a bond discount deduction of $5 per year over the ten-year life of the bond.[9]

Decisions of this Court have similarly recognized the nature of bond discount as an additional cost incurred in borrowing money. In considering the early Regulations[10] which described the discount as a "loss" to be "prorated over the life of the bonds sold," the Court in *Helvering* v. *Union Pacific Co.,* 293 U.S. 282, 284–285, referred to discount both as "interest paid

[8] Section 1232(b) was most recently amended by Sec. 5, Interest Equalization Tax Act, P.L. 88–563, 78 Stat. 809, and by Sec. 413(b), Tax Reform Act of 1969, P.L. 91–172, 83 Stat. 487.

[9] See Treasury Regulations on Income Tax (1954 Code), § 1.163–3(b), Example (1), Appendix, *infra,* p. 40.

[10] Treasury Regulations 33, Article 150 (1918 ed.).

for the use of capital procured by a bond issue" and as "a loss resulting from the funding operation * * * which is realized only upon the payment of the bonds at maturity" (293 U.S. at 286). See also *id.* at 287 and *Western Maryland Ry. Co.* v. *Commissioner,* 33 F.2d 695 (C.A. 4). Although the Regulations for a time thereafter classified discount as an interest expense deduction,[11] any characterization was subsequently abandoned.[12]

More recently, in *United States* v. *Midland-Ross Corp.,* 381 U.S. 54, the Court has been unambiguous in its characterization of the nature of discount. It stated (381 U.S. at 57 and 66):

> Earned original issue discount serves the same function as stated interest * * *; it is simply "compensation for the use or forbearance of money."

and that

> despite some expressions indicating a contrary view, this Court has often recognized the economic function of discount as interest.

2. Until the decision of the court of appeals below, it had been generally assumed that whether discount was characterized as an interest expense or as a loss was of no practical significance.[13] Under either

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[11] See, *e.g.*, Arts. 544(3)(a), 563 and 848 of Treasury Regulations 45 (1918 Revenue Act).

[12] See, *e.g.*, Treasury Regulations 111 (1939 Code), § 29.22(a)–17(3)(a).

[13] One of the grounds upon which the court below dismissed the Court of Claims decisions with which it disagreed was that they were based upon the premise that discount arose from loss rather than serving the function of interest. The court of ap-

terminology, a deduction for bond discount serves to reduce the tax liability of the issuing corporation. However, in order for bond discount to arise, there must be an outlay, or an obligation to make an outlay, in excess of the original capital borrowed.

This prerequisite, fundamental to the nature of discount, was the theoretical basis underlying the Court's decision in *Old Mission Co.* v. *Helvering,* 293 U.S. 289. There, the Court concluded that deductible discount on bonds issued by one corporation and held by an affiliate terminated when the corporations filed a consolidated tax return. In so holding, the Court analogized the case to that of a single taxpayer who purchases his own bonds before maturity. Because the obligation to pay the face amount at maturity lapsed, the issuer "could not afterwards deduct, from gross income, the amortized discount on the bonds, in anticipation of their payment at maturity" (293 U.S. at 292).

The foregoing principles similarly govern the question in this case—whether respondent's substitution of its 5% $50 face amount debentures for its previously outstanding $50 par, 5% preferred stock gave rise to deductible bond discount. As we shall demonstrate

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peals variously characterized this premise as "nonapplicable," "erroneous," and "unsound" (Pet. App. B 54, 58, 64). But the Court of Claims simply recognized the historically variant references to discount as loss and as interest, while correctly observing that the difference in terminology made no practical difference. Moreover, the Court of Claims stated that it would nevertheless treat discount as interest. *Erie Lackawanna Railroad Co.* v. *United States*, 422 F. 2d 425, 427–428, n. 7; *Missouri Pacific Railroad Co.* v. *United States*, 427 F. 2d 727, 730, modified, 433 F. 2d 1324, certiorari denied, 402 U.S. 944.

below in Part B, no bond discount arose because the transaction was merely a capital readjustment substituting one security for another. Under such circumstances, respondent incurred no obligation to pay anything in excess of the amount borrowed because of the substitution of securities. In this sense, the case should follow *a fortiori* from the analogy in *Old Mission,* where the obligation to pay an amount in excess of the borrowed capital lapsed upon the issuer's purchase of the bond before maturity. Here, where such an obligation never arose in the first place, there can be no deductible discount.

B. THE SUBSTITUTION BY A CORPORATION OF AN ISSUE OF ITS DEBENTURES FOR AN EXISTING ISSUE OF ITS PREFERRED STOCK IS NOTHING MORE THAN A RECAPITALIZATION WHICH DOES NOT GIVE RISE TO DEDUCTIBLE BOND DISCOUNT

1. The recapitalization did not result in an obligation to pay in excess of an amount borrowed

a. The court of appeals held that respondent's issuance of a debenture for a share of previously outstanding preferred stock gave rise to bond discount equal to the difference between the face amount of the debenture ($50) and the market value of the preferred stock ($33). But the shift from respondent's $50 par, 5% cumulative preferred stock to its 5% subordinated debentures in the face amount of $50 had no major investment significance either to respondent or to its preferred shareholders. The corporate assets were neither increased nor diminished.

To the extent there was any change, it benefited the corporation by giving it a tax deduction under Section 163 for the interest of 5% paid, whereas the 5% divi-

dends on the preferred stock would not have been deductible. The common stockholders, the beneficial owners of the corporation, were benefited by the elimination of the dividend arrearages on the preferred stock and by the elimination of the premium payable on its retirement. Debenture interest was fixed, but dividends on the preferred stock were cumulative, so that both securities would result in equal diminutions of earnings otherwise available for the common stockholders. The debentures were payable on a fixed date eighteen years after issuance, but comparable sinking fund provisions would retire both debentures and preferred stock if there were corporate earnings. The 5% cost of the capital invested in the corporation was the same, whether represented by preferred stock or by debentures.

As has often been noted, the investment difference between preferred stock and unsecured debentures is one of slight degree, and that difference is further diminished when, as here, the debentures are subordinated. Cf. *John Kelley Co.* v. *Commissioner,* 326 U.S. 521. From the standpoint of the preferred shareholders, the conclusion appears inescapable that their interest "was fairly reflected in the highly equivalent characteristics of the debentures into which the preferred [stock] was converted." *Penfield* v. *Davis,* 105 F. Supp. 292, 311 (N.D. Ala.), affirmed, 205 F. 2d 798 (C.A. 5). Under such circumstances, respondent did not, in any realistic sense, issue the $50 debentures at a discount representing the $17 difference between their face ($50) and market ($33) values.

b. The similarity between the terms of respondent's debentures and its previously outstanding preferred stock illustrates the fundamental legal principle governing cases of this type. It is that the substitution by a corporation of one security for another, without more, does not constitute the creation of an obligation to pay in excess of an amount borrowed upon which discount, as a cost of borrowing, can arise. This principle was the basis of Rev. Rul. 59–387, 1959–2 Cum. Bull. 56, in which the Internal Revenue Service ruled that a corporation's issue of its debentures and common stock in exchange for its outstanding preferred stock gave rise to no bond discount, and that the fair market value of the preferred stock was not a relevant factor in this determination. Instead, the transaction was deemed to be merely a capital readjustment in the form of a recapitalization.[14] We believe this Ruling to be correct in its general application and unquestionably sound as applied to the facts of this case.

The recent decision of the Fifth Circuit in *Claussen's, Inc.* v. *United States,* 469 F. 2d 340, where a comparable bond discount claim was rejected, rests upon similar reasoning. There, the taxpayer-corporation issued 6% debentures in the aggregate face amount of $2,250,000, plus new common stock and

[14] Respondent sought and obtained a ruling on whether gain or loss resulted to the corporation, to the common shareholders, and to the preferred shareholders from the recapitalization in this case. (R. 17–21.) No question was raised explicitly concerning bond discount. However, in holding that the preferred shareholders had capital gain or loss from receipt of the debentures (R. 20–21), the ruling necessarily indicated that no discount resulted to the corporation since discount to the corporation would have produced equivalent ordinary income to the recipients of the debentures. Sec. 1232(a)(2)(B).

stock purchase warrants, for previously outstanding common stock. Upon issuance of the original common stock, the corporation received an aggregate of $1,962,500, which had thereafter constituted its capital and paid-in surplus. That amount was also the value of the outstanding stock at the time of the exchange. The court of appeals denied the claim that the $362,500 difference constituted bond discount, pointing out that the corporation had acquired no new capital and that the shareholders had surrendered nothing to the corporation for which there could be a cost of borrowing.[15] On this basis, respondent's claimed bond discount deduction must likewise fail.[16]

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[15] The observations of the Fifth Circuit in *Claussen's* (469 F. 2d at 344, n. 11) are particularly appropriate. "We simply cannot overlook the complete lack of substance to the claims of the corporation here. Its assets were not diminished by a penny, either when the debentures were issued to the stockholders or where the face amount of the bonds was assumed by Fuqua (thus, presumably reducing the amount of the purchase price). The company paid nothing more to the bond-holders at any time than the current interest. It did not sell them to anyone at a discount. It issued them either as dividend, partial distribution of earned income and capital, or as 'boot' in a tax-free reorganization. It cannot deduct as interest what it has not paid out or become liable to pay out to anybody."

The court further noted (469 F. 2d at 344, n. 10) that in a slightly different context, this Court had held that an issue of bonds and stock for previously outstanding stock gave rise to a dividend. *Bazley* v. *Commissioner*, 331 U.S. 737. Cf. Sec. 356(a)(2) and (d) of the Code.

[16] The court of appeals (Pet. App. B 65, n. 7) attempted to distinguish the *Claussen's* case on the factual ground that the exchange was common stock and that the common stockholders' proportional equity was unchanged. While that fact graphically demonstrated that the transaction in *Claussen's* amounted to little more than a simple distribution of bonds, the critical fact, common to this case and *Claussen's*, is that the issuance of the debenture was not accompanied by the acquisition of any new capital.

c. The correctness of the approach in *Claussen's* and the Treasury Ruling can be further demonstrated by the following illustrative example. Suppose respondent, instead of issuing bonds for its outstanding preferred stock, had retired them with cash. When a corporation redeems shares of its stock for cash, the cash distribution gives rise to no deduction either for the par value of the stock, for a call or redemption premium (*John Wanamaker Philadelphia* v. *Commissioner,* 139 F. 2d 644 (C.A. 3); *Jewel Tea Co.* v. *United States,* 90 F. 2d 451 (C.A. 2); *H. and G. Industries, Inc.* v. *Commissioner,* 60 T.C. 163, on appeal to C.A. 3), or because the amount paid in redemption was more than the amount originally paid in for the stock. *Pacific Southwest Realty Co.* v. *Commissioner,* 128 F. 2d 815 (C.A. 9), certiorari denied, 317 U.S. 663. Cf. Secs. 311(a) and 336 of the Code. See also *United States* v. *Cumberland Pub. Serv. Co.,* 338 U.S. 451, 455.

It is therefore clear that had respondent paid its preferred shareholders in cash the $51 to which they were entitled upon the redemption of their preferred shares (R. 192),[17] or the lesser sum of $50, no part of such payment would have been deductible from gross income. But instead of a cash payment, it distributed its obligation for $50, bearing interest at 5%, the same rate at which the same investment had accrued a cumulative right to dividends when it existed in the form of preferred stock. There is

[17] A warrant to subscribe to common stock was distributed and accepted by the preferred shareholders in lieu of their right to dividend arrearages of $10 (R. 56–57, 192).

nothing to suggest that respondent was paying more than the stated rate of 5% as compensation for the use or forbearance of money (*United States* v. *Midland-Ross Corp.*, 381 U.S. 54, 57), and everything to indicate that the stated interest rate of 5% was respondent's entire obligation for the privilege of deferring payment. The fact that a few hundred shares of preferred stock had changed hands at prices lower than $50 in sporadic sales over a period of months (R. 167) does not indicate that the holders of all or of the required two-thirds (R. 176) of the 47,059 shares of preferred stock outstanding would have accepted less than $50 per share when respondent's directors proposed to retire the entire issue.

Since respondent would have obtained no deduction had it retired its preferred stock for $50 per share in cash, is it possible for it to produce a deduction of $17 per debenture by simply substituting its $50 interest-bearing obligation for $50 cash? The answer, we submit, is plainly no. The market value of the preferred stock for which the bonds were substituted can therefore have no relevance in determining the existence of discount.

2. The transaction is not analogous to the issuance of bonds for property because there was no acquisition of property

In holding that respondent was entitled to its claimed deduction for bond discount, the court below assimilated the transaction to one where bonds are issued for property without an agreement as to the purchase price of the property. With respect to this question, there was a pre-existing conflict of decisions as to the existence of discount in such a transaction (Pet.

App. B 59–64). By reasoning from such an analogy, the court disregarded the settled principle that a corporation's retirement of its own stock is not an acquisition of property. Thus, whatever the merits of the bonds-for-property question, which has now been settled by legislation for years after 1969 (see p. 23, n. 25, *infra*), it need not be resolved in this case. Nevertheless, in order fully to explain the analogy which led the court below into error, a brief description of the history of the bonds-for-property question is appropriate.

a. Where bonds are issued for cash, there are relatively few problems in determining whether discount exists and, if so, its amount.[18] Where bonds equal in face amount to the agreed purchase price of property are issued in payment of the price, the courts have long held that no discount arises and have refused to impute interest where the parties have not provided for it in their contract.[19] If the parties had agreed

[18] The question of the existence of discount on convertible obligations issued for cash at par is currently in litigation. *Hunt Foods and Industries, Inc.* v. *Commissioner*, 57 T.C. 633, on appeal to C.A. 9. Cf. *Chock Full O'Nuts Corp.* v. *United States*, 453 F. 2d 300 (C.A. 2); *AMF Incorporated* v. *United States*, 476 F. 2d 1351 (Ct. Cl.), petition for certiorari pending, October Term, 1973, No. 73–73.

[19] *United States* v. *Cornish*, 348 F. 2d 175 (C.A. 9); *Paine* v. *Commissioner*, 236 F. 2d 398 (C.A. 8); *M. C. Parrish & Co.* v. *Commissioner*, 147 F. 2d 284 (C.A. 5); *Elliott Paint & Varnish Co.* v. *Commissioner*, 44 B.T.A. 241.

Section 483 of the Internal Revenue Code of 1954, as added by Section 224(a) of the Revenue Act of 1964, P.L. 88–272, 78 Stat. 19, now permits the imputation of interest in any contract for the sale or exchange of property where the deferred sales price does not provide for interest or the interest rate is inadequate. It is effective only for payments made after December 31, 1963, on account of sales or exchanges of property occurring after June 30, 1963. The legislative history reflects

that the purchase price of property was $950, but the corporate purchaser issued its bond for $1,000 to acquire it, presumably there would be a $50 discount, and the cost of the property to the purchaser would be $950 for purposes of computing gain or loss upon subsequent disposition, or for purposes of depreciation.

The courts have disagreed, however, on the question whether discount arises in the case where the purchaser agrees that it will issue its bond in a stated amount, *e.g.*, $1,000, to acquire the property purchased without any agreement as to the purchase price. It appears, at least *prima facie,* that the cost of the property is $1,000 for computing gain or loss to the purchaser upon disposition, or for depreciation, and that accordingly no discount arises upon the transaction. The Court of Claims [20] and the Board of Tax Appeals [21] have held that this is the necessary result of the transaction, not only *prima facie,* but conclusively.

On the other hand, a divided Third Circuit had held to the contrary in *American Smelting & Refining Co.* v. *United States,* 130 F. 2d 883. There, where the property acquired by the taxpayer consisted of securities of its subsidiary which were traded on the

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that it represented a change in existing law. H. Rep. No. 749, 88th Cong., 1st Sess., pp. 72–74; S. Rep. No. 830, 88th Cong., 2d Sess., pp. 101–104. *United States* v. *Cornish, supra.*

[20] *Southern Natural Gas Co.* v. *United States,* 412 F. 2d 1222 (Ct. Cl.); *Montana Power Co.* v. *United States,* 159 F. Supp. 593 (Ct. Cl.).

[21] *Sacramento Medico Dental Building Co.* v. *Commissioner,* 47 B.T.A. 315.

New York Stock Exchange, that court concluded that it was open to demonstration that the price of the property (and cost to the buyer) was, to employ the example above, $950, despite the fact that it was acquired by the issuance of a bond in the principal amount of $1,000. If this demonstration were made, the court held that the $50 difference between the $950 cost of the property and the $1,000 face amount of the bond would constitute discount.[22] In view of the Third Circuit's subsequent *en banc* decision in *Commissioner* v. *Danielson*, 378 F. 2d 771, holding that courts should not permit a taxpayer to vary the agreed terms of a written purchase contract in order to reallocate cost and consideration for tax purposes, it is unlikely that it would now follow its *American Smelting* decision. Nevertheless, the Tenth Circuit did follow it in *Atchison, Topeka and Santa Fe R.R.* v. *United States*, 443 F. 2d 147, while noting (443 F. 2d, at 152) that its decision related to a pre-1913 transaction, when tax considerations would not have affected both buyer and seller.[23]

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[22] In a subsequent *en banc* decision, two judges of the Third Circuit noted their disagreement with the *American Smelting* ruling and one judge (who had been in the majority in *American Smelting*) adhered to his prior view. The majority of the court, however, found it unnecessary to decide the question. *Montana Power Co.* v. *United States*, 232 F. 2d 541, 545–550, 550–554 (C.A. 3), certiorari denied, 352 U.S. 843.

[23] Though *Nassau Lens Co.* v. *Commissioner*, 308 F. 2d 39 (C.A. 2) is frequently cited in this connection (Pet. App. B. 60, n. 6), we believe that the Second Circuit is not a participant in this disagreement. In that case the designated face amounts of notes, otherwise non-interest bearing prior to maturity, increased with the passage of time. The periodic increase on the

b. Whatever the merits of the bonds-for-property question,[24] settled by legislation for years after 1969,[25] its resolution is not necessary in this case. When respondent eliminated its $50 par, 5% cumulative preferred stock, and substituted therefor its 5% debentures in the face amount of $50, it did not acquire any property or any new assets. The question of discount on a bonds-for-property exchange therefore did not arise. In purporting to follow and apply its previous decision in *Atchison, Topeka,* which relied in turn upon the questionable *American Smelting* holding (Pet. App. B 59-64), the court below misconceived the transaction before it.

The fundamental error of the court below was to view respondent's cancellation of its preferred stock as an acquisition of property in the usual sense. But when a corporation distributes money or property to a

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face of the notes could easily be recognized as interest or its discount equivalent.

[24] We believe the opinion of Judge Kalodner in *Montana Power* and the opinions of the Court of Claims, *supra*, are the more persuasive.

[25] As amended to apply to bonds issued after May 27, 1969, Section 1232(b)(2), Appendix, *infra*, pp. 37-39, provides, with several stated exceptions, that the issue price of a bond which is issued for property is the face amount. Hence, there would be no discount. The exceptions relate to bonds traded on an established securities market and to bonds issued for stock or securities which are traded on an established securities market. See Section 1232(b)(2) (A) and (B), Appendix, *infra*, p. 38. Under these circumstances, the issue price would be the fair market value of the property and discount equal to the difference between that value and the face amount of the bond would arise.

shareholder who surrenders his shares of corporate stock, it acquires no property. "[S]ince a corporation's own shares are not assets, but only the convenient machinery for evidencing shareholder interests, it is a fallacy to say it has received anything * * *." *Houston Brothers Co.* v. *Commissioner,* 21 B.T.A. 804, 815. See also *375 Park Avenue Corp.* v. *Commissioner,* 23 B.T.A. 969, 973; *Johnson* v. *Commissioner,* 56 F. 2d 58 (C.A. 5); and *Claussen's, Inc.* v. *United States,* 469 F. 2d 340, 344 (C.A. 5). Cf. Section 317(a) of the Code. Moreover, generally accepted accounting practice has recognized the principle, since it does not treat treasury stock as an asset. See Wixson, Kell and Bedford, *Accountants' Handbook* (5th ed. 1970), p. 21.31.

Similarly, where, as here, a corporation substitutes one issue of securities for another, it receives no property upon cancellation of the old security. Such a transaction is, as respondent's directors characterized it (R. 56), a recapitalization, or as this Court described it, a "reshuffling of a capital structure, within the framework of an existing corporation." *Helvering* v. *Southwest Corp.,* 315 U.S. 194, 202. Under the Internal Revenue Code, such a transaction is not regarded as an acquisition of property by the corporation with respect to which the usual rules of gain or less apply. To the contrary, it is treated as a simple adjustment to the capital structure of the corporation, not giving rise to income or deduction to the corporation. *Commissioner* v. *Capento Securities Corp.,* 140 F. 2d 382 (C.A. 1); Rev. Rul. 59–222, 1959–1 Cum. Bull. 80.

Even when a corporation acquired shares of its own stock, held the shares as treasury stock, and later

reissued them at a price greater than it had paid to acquire the shares, gain was recognized to the corporation, prior to 1954, only in limited circumstances where the corporation had dealt in its own shares as it might in the shares of another corporation. *Helvering* v. *Reynolds Co.*, 306 U.S. 110; *United States* v. *Anderson, Clayton & Co.*, 350 U.S. 55. Since 1954, gain under even such limited circumstances has been eliminated by Section 1032 of the Internal Revenue Code of 1954.

Moreover, even the restricted concept of property made applicable in limited circumstances to treasury shares prior to 1954 would not have been applicable to respondent's preferred shares. While the preferred issue was outstanding, any shares redeemed could not be re-issued; they would be cancelled, and the number of authorized shares correspondingly reduced (R. 196). In 1957, by vote of its directors and shareholders, respondent simply eliminated its preferred shares by amendment of its certificate of incorporation pursuant to 8 Del. Code Ann., Section 242. As the shareholders were informed (R. 176), this elimination was not a matter of choice or bargaining by the individual shareholder, but took place by operation of law. *Goldman* v. *Postal Telegraph, Inc.*, 52 F. Supp. 763 (D. Del.); *Morris* v. *American Public Utilities Co.*, 14 Del. Ch. 136, 122 Atl. 696.

Under no circumstances could respondent be viewed as dealing in its own shares as it might in the shares of another corporation. No such dealing was possible since the preferred stock was cancelled immediately

upon acquisition. Thus, even if the *American Smelting* rationale for bond discount were accepted, it could not apply here since respondent acquired no property when it eliminated its preferred stock.

3. The transaction cannot be analogized to the issuance of $50 face amount debentures for $33 in cash and the subsequent retirement of the preferred stock for $33 per share

The court below further rationalized its result by assimilating respondent's substitution of its debentures for its preferred stock to a transaction in which respondent had issued its $50 debentures for $33 cash, and then used the cash to retire the preferred stock at $33 per share (Pet. App. B 53–55). Under this analysis, the court below observed that (Pet. App. B 55) "[t]he picture looks quite different when the result is thus broken down." We submit that such a division of respondent's unified transaction into the suggested non-existent hypothetical components would not produce the result anticipated by the court below.

It is the transaction actually accomplished by respondent and not some speculative variation, that the court had to pass upon. As the Second Circuit has observed, "It would be quite intolerable to pyramid the existing complexities of tax law by a rule that the tax shall be that resulting from the form of transaction taxpayers have chosen or from any other form they might have chosen, whichever is less." *Television Industries, Inc.* v. *Commissioner,* 284 F. 2d 322, 325.

At all events, the hypothetical example has neither a factual nor legal basis. Factually, there is nothing in the record to establish the price at which respondent

would have been able to issue its debentures, had it sought to sell them for cash. And, as we have noted, a few sporadic sales of small lots of preferred shares do not establish, or even suggest, that all, or even a majority, of the preferred shareholders would have accepted $33 per share when respondent proposed retiring the entire issue. The intention of management to retire an issue of preferred stock will of course, when known, move a lower market price up to or toward the redemption price.

But quite apart from the factual deficiencies of the court's speculative discussion, its assimilation of a substitution of one issue of securities for another to a two-step issue-for-cash-plus-cash-redemption flies squarely in the face of this Court's unanimous rejection of such a contrary-to-fact analysis in *Great Western Power Co.* v. *Commissioner,* 297 U.S. 543, 546–547. There, the Court held that for purposes of determining the existence and amount of discount upon the substitution or exchange of one issue of securities for another, the transaction must be viewed as a continuum, and could not be assimilated to the sale of one issue for cash and the retirement of the other with the proceeds. The lower courts have followed and applied this decision. See, *e.g., Chicago, Milwaukee, St. Paul & Pacific R. Co.* v. *United States,* 404 F. 2d 960 (Ct. Cl.); *Bridgeport Hydraulic Co.* v. *Commissioner,* 22 T.C. 215; *South Carolina Continental Telephone Co.* v. *Commissioner,* 10 T.C. 164. Cf. *Commissioner* v. *Capento Securities Corp., supra,* 140 F. 2d at 385–387. The clear impact of these decisions, which the court below disregarded, refutes its two-step analysis of re-

spondent's substitution of debentures for preferred stock, The court's ultimate finding of discount, which rests upon such discredited reasoning, must similarly be rejected.

C. NO DISCOUNT COULD ARISE UPON RESPONDENT'S SUBSTITUTION OF A $50 DEBENTURE FOR A SHARE OF PREFERRED STOCK FOR WHICH IT HAD PREVIOUSLY RECEIVED $50

In upholding the deficiencies determined by the Commissioner, the Tax Court followed a series of recent decisions of the Court of Claims.[26] These cases, as applied to the transaction at issue, held that no discount could arise when respondent substituted a debenture in the face amount of $50 for a share of its $50 par preferred stock for which it had received $50 upon issuance.[27] In view of this Court's *Great Western* holding that the substitution of one security issue for another constitutes a continuum for purposes of determining the existence and computation of discount, the Tax Court was correct as a matter of simple arithmetic computation. There can be no discount when a corporation receives $50 and issues its obligations in the face amount of $50.

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[26] *Erie Lackawanna Railroad Co.* v. *United States*, 422 F. 2d 425; *Missouri Pacific Railroad Co.* v. *United States*, 427 F. 2d 727, modified, 433 F. 2d 1324, certiorari denied, 402 U.S. 944; *St. Louis-San Francisco Railway Co.* v. *United States*, 444 F. 2d 1102, certiorari denied, 404 U.S. 1017.

[27] It has been assumed throughout that respondent's $50 par preferred stock was issued for at least $50 per share, and nothing in the record suggests that it was issued for less. Under Delaware law, the shares could not have been issued for less. *Yasik* v. *Wachtel*, 25 Del. Ch. 247, 254, 17 A. 2d 309, 312.

Under the decision of the Tax Court in this case and those of the Court of Claims, the arithmetical equivalence between the face amount of the debenture and the amount originally obtained upon the issuance of the preferred stock is sufficient to negate the existence of discount. We believe that the rejections of the bond discount claims in those cases are correct in result. An adoption by this Court of the reasoning of those decisions would therefore be adequate for the disposition of this case to require reversal of the judgment below.

It is our position, however, that the arithmetical equivalence relied upon by the Tax Court and the Court of Claims is a misleading basis for the rejection of a bond discount claim in cases of this type.[28] Accordingly, we have urged in Part B, supra, a broader basis of decision: that a capital readjustment in the form of a recapitalization of this type does not give rise to bond discount. But since the Court may reach the theory of arithmetical equivalence, we explain why we consider certain aspects of the decisions announcing and applying that principle to be erroneous.

In *Erie Lackawanna Railroad Co.* v. *United States*, 422 F. 2d 425 (Ct. Cl), the taxpayer-corporation exchanged its $100 debentures for its shares of $100 par preferred stock. The Court of Claims held that no discount could arise on the issuance of the $100 debentures since the corporation had received $100 upon the

[28] The Fifth Circuit noted its doubt as to the basis of those decisions in *Claussen's, Inc.* v. *United States*, 469 F. 2d at 342–343.

issuance of each share of preferred stock. It explicitly left undecided what the result would have been had the preferred shares been issued for less than $100 (422 F. 2d at 430). Subsequently, in *Missouri Pacific Railroad Co.* v. *United States,* 427 F. 2d 727 (Ct. Cl.), the facts with respect to several bond issues paralleled those of *Erie Lackawanna,* and the Court of Claims followed its earlier decision. There were, however, two issues of bonds exchanged for outstanding securities, where the security first issued had been issued for less than the face amount of the bonds issued in exchange. As to these exchanges, the court found discount in the amount of the difference (427 F. 2d at 733–734).

On rehearing, the Court of Claims modified its decision with respect to these two bond issues. The change adopted was to approve the rationale of the intervening district court decision in *Cities Service Co.* v. *United States,* 316 F. Supp. 61 (S.D. N.Y.), reaffirmed, 330 F. Supp. 421, supplemental opinion, 362 F. Supp. 830,[29] which held that upon such an exchange of bonds for previously issued securities, discount, if any, was the difference between the face amount of the bonds and the greater of: (a) the amount for which the prior securities had been issued or (b) the value to the corporation of the previously issued securities at the time of the exchange.[30] 433

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[29] Final judgment has not yet been entered in this case.

[30] Under the *Cities Service* formula, the value to the corporation of the original securities might be greater but never less than the amount for which they were originally issued (316 F. Supp. at 72). Thus, the latter amount constitutes a floor for purposes of measuring discount.

F. 2d 1324. Applying this *Cities Service* formula, the Court of Claims found on rehearing in *Missouri Pacific* that the value of the prior securities to the corporation was equal to the face amount of the bonds, and that hence, no discount arose (433 F. 2d at 1325–1326). The court stated that there was a difference between the terms "value to the corporation" and "fair market value" (433 F. 2d at 1326). Finally, in *St. Louis-San Francisco Railway Co.* v. *United States,* 444 F. 2d 1102, where the facts paralleled those of *Erie Lackawanna,* the court explicitly differentiated between the two terms (444 F. 2d at 1105–1106). However, it never indicated the precise meaning of the concept "value to the corporation."[21] Whatever its meaning might be, we do not believe that either the issue price of stock or its "value to the corporation" can contribute a valid measure for the determination of discount upon a recapitalization.

If we assume that the latter term means the amount which the corporation agrees to pay for the stock, no discount could exist because the face amount of the debenture will, at all times, be equal to the value of the stock "to the corporation." And though, as a matter of simple arithmetic, discount cannot exist if a corporation issues stock for $50 and then substitutes a $50 obligation for each share of stock, it by no means follows, as the *Cities Service* formula suggests, that discount does arise if the substituted obligation is issued in the face amount of $55.

[21] In *Cities Service*, the district court similarly differentiated between the two terms. In determining the value to the corporation of the preferred stock, it stated that its fair market value was "relevant" but not "conclusive" (316 F. Supp. at 73).

There are many circumstances that will lead to a corporation's redeeming shares of stock for more than was paid in upon issuance. A share of $50 par preferred issued for $50 may have a call or redemption price of $55. A share of no-par preferred may have been issued for $40, but have a right prior to the common to $50 upon liquidation or redemption. A share of common stock, or of participating preferred, may have been issued for $50, but growth of the enterprise may have increased the shareholder's equity to $60 or more per share.

As we have previously pointed out, the corporation would not be entitled to any deduction if it paid cash to redeem these shares at the higher figure. There is no reason why issuing its interest-bearing obligation [22] in the face amount of the cash it might and would otherwise have paid, should convert the non-deduction into a deduction. Since discount serves the function of interest, or compensation for the use or forbearance of money (*United States* v. *Midland-Ross Corp.*, 381 U.S. 54, 57), an obligation in the face amount of the redemption price that would otherwise have been paid in cash refutes rather than supports the presence of discount, whatever may have been the original issue price.

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[22] If a share of $50 par preferred stock, issued for $50, had a call price of $55, and the corporation upon call did not pay cash, but delivered its *non-interest-bearing* obligation, payable two years from date, in the face amount of $60, there might be a strong factual inference that the $5 difference between the call price and $60 was interest, or discount. But prior to the enactment of Section 483 (see n. 19, *supra*) the courts have consistently refused to impute interest in such circumstances.

Conversely, if the term "value to the corporation" is not identical with the amount the corporation agrees to pay, it will still not be able to establish or measure interest or discount in such a transaction. There are many reasons set forth in the reported decisions why a corporation may wish to convert an issue of stock into obligations, either by voluntary exchange or by shareholders' vote. It may seek the tax deduction that the payment of interest, but not of dividends, will give. See, *e.g.*, *Schoo* v. *Commissioner*, 47 B.T.A. 459. It may seek to eliminate a dissident minority. See, *e.g.*, *Hickok* v. *Commissioner*, 32 T.C. 80. It may seek to shift the equity position from a retired former management group to the current management. See, *e.g.*, *Wolf Envelope Co.* v. *Commissioner*, 17 T.C. 471. It may wish to eliminate dividend arrearages. See, *e.g.*, *Seide* v. *Commissioner*, 18 T.C. 502.

To accomplish these or other purposes, it may be necessary to offer a price greater than market or some amount more vaguely ascertained as "value to the corporation" in order to obtain consent, though it would appear that the price it offers is the best and conclusive evidence of value to the corporation. But whatever elements may enter into the determination of the face amount of its obligations that the corporation may decide to offer in substitution for outstanding stock, there is nothing in any of these cases that would support imputing to the face amount of the obligation an element of compensation for the use or

forbearance of money, particularly where the obligation is itself interest-bearing.[33]

[33] The claim of discount in *Gulf, Mobile and Ohio Railroad Co.* v. *United States*, 339 F. Supp. 489 (S.D. Ala.), final decision, 31 A.F.T.R. 2d 73–436, on appeal to C.A. 5, furnishes an example of the uncertain results of the application of the Court of Claims' theories for ascertaining discount. In 1957, the corporation sought and obtained authorization from the Interstate Commerce Commission as required by Section 20a of the Interstate Commerce Act (49 U.S.C. 20a), to issue 5% income debentures in exchange for its outstanding $5 preferred stock. The stated purpose of the proposed exchange, and the basis for authorization, was the tax advantage of the interest deduction. After issuing the debentures in lieu of the previously outstanding preferred stock, the corporation then claimed a deduction for discount.

Purporting to follow the Court of Claims' decisions, the district court upheld the claim for discount and made its own decision on the value of the property received for the preferred in 1940 shortly after the corporation was organized. But in so doing, it disregarded the valuation and authorization of capitalization by the Interstate Commerce Commission (*Gulf, Mobile & Ohio Railroad Company Merger*, 236 I.C.C. 61), as required by Sections 5(2) and 20a of the Interstate Commerce Act (49 U.S.C. 5(2) and 20a). Cf. *Atlanta, B. & C. Ry. Co.* v. *United States*, 296 U.S. 33; *New York, Chicago & St. Louis R. Co.* v. *Frank*, 314 U.S. 360, 365. It found discount measured by the difference between the market value of the preferred stock at the time of the exchange and the face amount of the debentures, notwithstanding the fact that the Court of Claims has specifically rejected market value of the outstanding security as a criterion for measuring discount. By joint motion, the proceedings on appeal in the Fifth Circuit have been deferred to await the Court's decision in this case.

Compare the similar disregard by the district court in *Cities Service Co.* v. *United States*, *supra*, 316 F. Supp. at 66–69, of the valuation and capitalization approved by the Securities and Exchange Commission.

CONCLUSION

For the reasons stated, the judgment of the court of appeals should be reversed.

Respectfully submitted.

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NOVEMBER 1973.

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 163. INTEREST.

(a) *General Rule.*—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

* * * * *

SEC. 1232. BONDS AND OTHER EVIDENCES OF INDEBTEDNESS.

* * * * *

(b) *Definitions.*—

(1) *Original issue discount.*—For purposes of subsection (a), the term "original issue discount" means the difference between the issue price and the stated redemption price at maturity. If the original issue discount is less than one-fourth of 1 percent of the redemption price at maturity multiplied by the number of complete years to maturity, then the issue discount shall be considered to be zero. For purposes of this paragraph, the term "stated redemption price at maturity" means the amount fixed by the last modification of the purchase agreement and includes dividends payable at that time.

(2) [as amended by Sec. 5, Interest Equalization Tax Act, P.L. 88-563, 78 Stat. 809, and Sec. 413(b), Tax Reform Act of 1969, P.L. 91-172, 83 Stat. 487] *Issue price.*—In the case of issues of bonds or other evidences of indebtedness registered with the Securities and Exchange Commission, the term "issue price" means the initial offering price to the public (excluding bond houses and brokers) at which price a substantial amount of such bonds or other evidences of indebtedness were sold. In the case of privately placed issues of bonds or

other evidence of indebtedness, the issue price of each such bond or other evidence of indebtedness is the price paid by the first buyer of such bond increased by the amount, if any, of tax paid under section 4911 (and not credited, refunded, or reimbursed) on the acquisition of such bond or evidence of indebtedness by the first buyer. For purposes of this paragraph, the terms "initial offering price" and "price paid by the first buyer" include the aggregate payments made by the purchaser under the purchase agreement, including modifications thereof. In the case of a bond or other evidence of indebtedness and an option or other security issued together as an investment unit, the issue price for such investment unit shall be determined in accordance with the rules stated in this paragraph. Such issue price attributable to each element of the investment unit shall be that portion thereof which the fair market value of such element bears to the total fair market value of all the elements in the investment unit. The issue price of the bond or other evidence of indebtedness included in such investment unit shall be the portion so allocated to it. In the case of a bond or other evidence of indebtedness, or an investment unit as described in this paragraph (other than a bond or other evidence of indebtedness or an investment unit issued pursuant to a plan of reorganization within the meaning of section 368(a)(1) or an insolvency reorganization within the meaning of section 371, 373, or 374), which is issued for property and which—

(A) is part of an issue a portion of which is traded on an established securities market, or

(B) is issued for stock or securities which are traded on an established securities market,

the issue price of such bond or other evidence of indebtedness or investment unit, as the case

may be, shall be the fair market value of such property. Except in cases to which the preceding sentence applies, the issue price of a bond or other evidence of indebtedness (whether or not issued as a part of an investment unit) which is issued for property (other than money) shall be the stated redemption price at maturity.

* * * * *

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§ 1.61–12 [as republished in T.D. 6500, 25 Fed. Reg., Part 11, pp. 11402, 11442–11443] *Income from discharge of indebtedness.*

* * * * *

(c) *Sale and purchase by corporation of its Bonds.* * * *

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(3) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. If the corporation purchases any of such bonds at a price in excess of the issuing price plus any amount of discount already deducted, the excess of the purchase price over the issuing price plus any amount of discount already deducted (or over the face value minus any amount of discount not yet deducted) is a deductible expense for the taxable year. If, however, the corporation purchases any of such bonds at a price less than the issuing price plus any amount of discount already deducted, the excess of the issuing price, plus any amount of discount already deducted (or of the face value minus any amount of discount not yet deducted), over the purchase price is income for the taxable year.

* * * * *

§ 1.163–3 [as amended by T.D. 6984, 1969–1 Cum. Bull. 38] *Deduction for bond discount.*

(a) *Discount upon issuance.* (1) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. For purposes of this section, the amortizable bond discount equals the excess of the amount payable at maturity (or, in the case of a callable bond, at the earlier call date) over the issue price of the bond (as defined in paragraph (b)(2) of § 1.1232–3).

* * * * *

(b) *Examples.* The rules in paragraph (2) of this section are illustrated by the following examples:

Example (1). M Corporation, on January 1, 1960, the beginning of its taxable year, issued for $95,000, 3 percent bonds, maturing 10 years from the date of issue, with a stated redemption price at maturity of $100,000. M Corporation should treat $5,000 ($100,000−$95,000) as the total amount to be amortized over the life of the bonds.

* * * * *

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* * * * *

(b) *Examples.* The rules in paragraph (2) of this section are illustrated by the following examples:

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DEC 28 1973
MICHAEL RODAK, JR., CLERK

In The Supreme Court of The United States

OCTOBER TERM, 1973

No. 73-9

COMMISSIONER OF INTERNAL REVENUE,

Petitioner

v.

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF OF AMICUS CURIAE

WHITE, PRICE, PETERSON & ROBINSON
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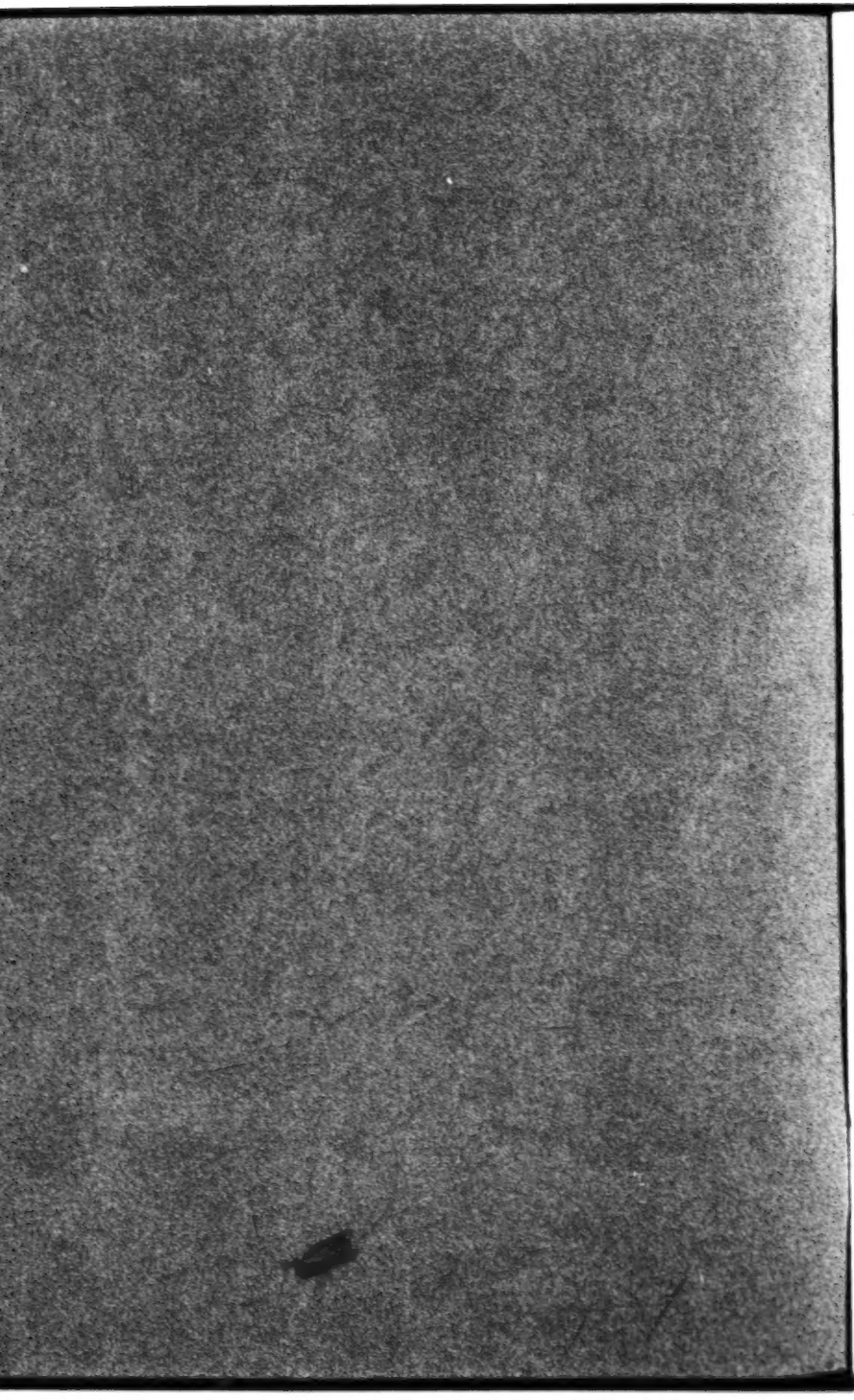

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IN THE SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1973

No. 73-9

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

v.

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY.

BRIEF OF AMICUS CURIAE

STATEMENT OF INTEREST

The Fed-Mart Corporation ("Fed-Mart") deducted on its Federal Income Tax Return for its fiscal year ended September 3, 1967, bond discount expense of $87,750.77 which resulted because of Fed-Mart's exchange in 1967 of $2,835,900.00 principal amount of its 6-12% junior subordinated debentures, dated February 1, 1987, for 226,872 shares of its outstanding common stock. Fed-Mart deducted $87,750.77 as a bond discount expense under Section 163 of the Internal Revenue Code and Regulation Section 1.163-3 (b) (1) on its Federal Income Tax Return for its fiscal year ended September 3, 1967. Upon audit, this deduction was disallowed.

The total tax alleged to be owed by the Internal Revenue Service was $673,206.11. A timely claim for refund was filed on or about December 1, 1972, with the Internal Revenue Service Center, Fresno, California, in the amount of $42,120.37, together with assessed interest in an amount of $12,649.95, plus any other amount which was legally refundable.

Fed-Mart received a notice dated March 29, 1973, stating that its claim for refund was disallowed in full.

On June 8, 1973, Fed-Mart filed a Complaint in the United States District Court, Southern District of California, as plaintiff against the United States of America as defendant for the recovery of Internal Revenue Service taxes praying that judgment be entered in its favor for $54,770.32, together with interest as provided by law.

The Department of Justice, by its attorney Robert Livingston, has filed an Answer praying that judgment be entered in its favor, dismissing Fed-Mart's Complaint with prejudice and granting the United States its costs. The case is now at issue.

Similar claims for refund involving the same exchange and deduction of bond discount have been filed regarding Fed-Mart's fiscal years ended September 1, 1968, August 31, 1969, and August 30, 1970.

PURPOSE AND APPROACH OF BRIEF

The purpose of this brief is to present a common sense and simplified approach, analysis, and solution to the question whether bond discount may arise when a corporation exchanges its debenture for its previously issued and outstanding stock. The argument and examples relate to transactions occurring before May 27, 1969 (the effective date for the change in Section 1232 of the Internal Revenue Code).

The approach is predicated upon accepted law that bond discount is interest, even though unstated or deferred, which is deductible exactly the same as stated interest under Section 163 (a) of the Internal Revenue Code of 1954.[1] The approach contained herein argues that unstated interest on indebtedness, as well as stated interest, is deductible without regard to the reason or manner in which the indebtedness was incurred.

ARGUMENT

Bond Discount is Interest Expense.

The starting point for analysis should be the simplest example possible where it is clear that bond discount is deferred interest. The Government in its brief uses the following example:

> "The prototype transaction where discount arises is one where a corporation receives

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[1] Treasury Regulation Section 1.163-1 (a) (1); Internal Revenue Code Section 163 (a).

> $950.00 upon the issuance of its bond in the face amount of $1,000.00, payable ten years after issuance. While the bond may have a stated annual interest rate of 5% so that the holder receives $50.00 per year, the $50.00 difference between the issue price ($950.00) and the face amount ($1,000.00) represents an additional cost to the corporation for the use of money of $5.00 per year over the ten-year life of the bond. Accepted accounting practice treats discount as deferred interest."[2]

In the above example, the difference between the issue price and the face amount is deferred interest which the corporation must pay to the bond holder at the maturity date. Such deferred interest is amortizable over the life of the bond.

The amount of the deferred interest will vary depending upon the interest rate of the bond as the issue price of the bond varies with the interest rate. As the stated interest rate decreases, the issue price of the bond will decrease, and conversely, if the stated interest rate increases, the issue price will increase. For example, a corporation may be able to receive $950.00 for a $1,000.00 bond bearing a 5% interest rate whereas it may only be able to receive $900.00 for a $1,000.00 bond bearing a 3% interest rate. In either case, the amount by which the face amount of the bond exceeds its issue price is an additional interest expense.

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[2] Petitioner's Brief, page 10.

Moving to the next example, suppose that instead of receiving cash for its bond, a corporation received property which was not its own stock. In this case, the discount would still be the excess, if any, of the face amount of the bond over the fair market value of the property on the date of the exchange. The sole difference in this example is that instead of receiving cash, the corporation received property, the fair market value of which is used for determining the amount of the unstated interest or bond discount.

The next question is whether bond discount may arise if the corporation received its own stock in exchange for its bond. The Government argues in its brief that in order for bond discount to arise in this case, there must be an acquisition of property.[3] This statement is irrelevant. The question is not whether there is an acquisition of property, but simply whether there is deferred interest on an incurred indebtedness. Why the indebtedness is incurred or what the corporation received for the indebtedness is irrelevant, provided the debt is bona fide. Interest is deductible under Section 163. Unstated or deferred interest is also deductible under Section 163 in the same manner as stated interest. Since the issue price of the bond varies with the stated interest rate, the amount of the stated interest rate is one factor in determining the interest expense arising from the obligation. The fact that property is or is not acquired is meaningless so long as there is a bona fide indebtedness incurred and there is interest on the debt. No one has or can argue that the stated interest rate is not deductible by the respondent corporation. Therefore, as the stated interest rate is only one factor in the determina-

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[3] Petitioner's Brief, pages 19-26.

tion of interest expense, the amount by which the face amount of the bond exceeded its fair market value (issue price) at time of issuance must also be taken into consideration in determining the entire interest cost.

In Deputy v. duPont, 308 U.S. 488, 498, this Court interpreted the term "interest on indebtness" to mean "compensation for the use or forbearance of money." The actual interest rate on the $50.00 bond is "compensation for the use or forbearance of money" as this Court has interpreted the term "interest on indebtedness." The unstated or deferred interest in this case, like the stated interest, is part of the forbearance of money -- i.e., instead of the corporation paying the debt or bond principal currently, it has agreed to pay interest and part of the interest is deferred to the date the bond matures. Simply stated, bond discount is deferred or unstated interest on an indebtedness which may be amortized over the term of the indebtedness and deducted under Section 163 of the Internal Revenue Code of 1954. The key is bona fide indebtedness, not the reason the debt was incurred or the type of consideration received except for the purpose of determining the unstated interest on the debt.

Interest Expense May Arise Even in a Recapitalization.

Likewise, the Government's argument and the position of the Internal Revenue Service[4] that there can

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[4] Petitioner's Brief, pages 14-19; Revenue Ruling 59-387, 1959-2 Cum. Bull. 56.

be no bond discount in a readjustment of the corporation's own securities in a form of recapitalization because there is no loss, is incorrect. Bond discount is not deductible because a corporation incurred a loss, but simply because the bond discount is unstated interest.

The Government argues in its brief that "in order for bond discount to arise, there must be an outlay or an obligation to make an outlay, in excess of the original capital borrowed."[5] Although this statement standing alone may be correct, it must be analyzed with reference to stated interest. Since bond discount is interest, even though unstated, the statement quoted applies equally to stated interest -- i.e., in order for stated interest to arise, there must be an outlay or an obligation to make an outlay in excess of the original capital borrowed. First, no one has or can argue that stated interest is not deductible and, therefore, there must have been an obligation to make an outlay in excess of the original capital borrowed. On the same principle, unstated interest would also meet the test. Second, the fundamental question is the issue price of the bond. If the issue price is less than the face amount of the bond, there is by definition an obligation to make an outlay ($50.00) in excess of the original capital borrowed (the issue price of the bond). It must be kept in mind that in order to be entitled to a deduction for stated interest, all that need be present is an indebtedness. A corporation can create debt in any manner it chooses even by acquiring its own stock and substituting its debt obligations. The unstated interest on the debt obligation is deductible as is stated interest.

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5 Petitioner's Brief, page 13.

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5 Petitioner's Brief, page 13.

The Original Issue Price of the Stock is Irrelevant.

The next issue is whether it is relevant that the corporation which issued the bond had received consideration equal to the face value of the bond when the stock it received in the exchange was originally issued. This fact is irrelevant if the sole issue is whether there is unstated interest on the debt. The discount has nothing to do with the nature of the property received in the exchange except to determine the amount of the unstated interest. An approach which takes into consideration the nature or value of the property originally received for the stock is viewing a bond discount as a loss. It is not a loss -- it is interest.[6] The original issuance of the stock was a closed transaction. The issuance of the bonds was a separate transaction in which the corporation incurred a debt plus an obligation to pay stated and deferred interest thereon. The reason or manner in which a bona fide debt is incurred is irrelevant under Section 163.

The Evidence Indicates that the Issue Price Was Less than Face Value.

The basic issue in this case is the issue price of the bonds. If it is less than the face amount, there must by definition be bond discount.

The Government has argued in its brief that "there is nothing to suggest that respondent was paying more than the stated rate of 5% as compensation for the use

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6 U.S. v. Midland-Ross Corp., 381 U.S. 54; see Petitioner's Brief, page 12.

or forbearance of money . . . "[7] However, this argument merely strengthens the position set forth herein that if it is found as a fact that an issuer is paying more than the stated rate (however determined), then there is additional interest expense. And, contrary to the Government's position, there is sufficient evidence to sustain a holding that the issue price in the instant case was equal to $33.00 per bond (the indicated fair market value of the preferred stock received in exchange). Therefore, respondent was, in fact, paying more than the stated interest rate.

In summary, bond discount is unstated interest which should be deductible exactly the same as stated interest. The difference between the issue price of the bonds and the face amount of the bonds is always unstated interest.

CONCLUSION

For the reasons stated herein, the judgment of the Court of Appeals should be affirmed.

Respectfully submitted,

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[7] Petitioner's Brief, pages 18-19.

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In the Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-9

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,
v.
NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE RESPONDENT

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In the Supreme Court of the United States

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No. 73-9

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE RESPONDENT

QUESTION PRESENTED

Whether respondent's *redemption*, through the one-for-one exchange of its 5 percent, 18 year, sinking fund debentures in the face amount of $50.00 for each share of its outstanding $50.00 par, 5 percent cumulative preferred stock with a fair market value of $33.00, gave rise to amortizable original issue bond discount on each debenture in the amount of $.95 per year or an additional 1.9 percent annual interest.

STATUTES AND REGULATIONS INVOLVED

Those code sections[1] and regulations set forth by the petitioner are pertinent to this case, however, petitioner has failed to clearly distinguish which code sections and regulations dealing with original issue bond discount were in effect in 1957 when the exchange transaction in this case occurred and during the period up to and including 1967 when the respondent's deductions for discount were subsequently disallowed. Furthermore, the petitioner has failed to set forth the pertinent provisions of Sections 302, 311 and 317 of the Code which deal with redemptions. The applicable code section, Section 163(a), and regulation, Treasury Regulation on Income Tax Section 1.61-12(c)(3), dealing with original issue bond discount as they appeared in 1957 and during the period up to and including 1967, as well as the pertinent portions of Sections 302, 311 and 317 dealing with redemptions are set forth in the text of respondent's argument which follows as well as in Appendix A, *infra*, pp. 35-38.

STATEMENT

The respondent, National Alfalfa Dehydrating and Milling Company (hereinafter referred to as "NAD"), was incorporated on May 4, 1946 under the laws of the State of Delaware, and engages in the business of milling and dehydrating alfalfa. (R. 24, 188)[2] NAD was initially capi-

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1. All references to the Code or sections of the Internal Revenue Code stated herein are references to the Internal Revenue Code of 1954 unless otherwise stated.

2. "R." references are to the separately bound record appendix. "Pet. App." references are to the Appendices to the petition for certiorari to which reference has also been made by the petitioner.

talized with preferred stock as well as common stock. (R. 125, 189) Prior to the exchange of its debentures for its outstanding preferred stock, which occurred in 1957 and which is the transaction under analysis here, NAD had 47,059 shares of $50 par, 5 percent cumulative preferred stock outstanding. (R. 25) Due to NAD's poor financial condition, dividends on that preferred stock were significantly in arrears. (R. 25) The preferred stock was trading in the over-the-counter market at $33.00 per share just prior to the exchange. (R. 161, 167)

NAD, in hopes of improving its financial picture and increasing its earnings, decided in 1957 to expand into more profitable eastern markets. (R. 25) NAD found, however, that its credit rating was so poor, due in part to the dividend arrearages, that it could not obtain lines of credit from lenders necessary to allow expansion into the eastern markets. Therefore, in order to accomplish the expansion it was necessary for NAD to attempt to improve its financial picture. Thus, in July, 1957, NAD redeemed its outstanding preferred stock through an exchange of its new debentures for the outstanding preferred stock and an exchange of warrants (to purchase NAD's common stock) for the dividend arrearages. To further strengthen the equity section of its balance sheet NAD exchanged new $3.00 par value common stock for its outstanding $1.00 par value common stock. (R. 57)

Fidelity-Philadelphia Trust Company agreed to transact the exchanges and to act as the Trustee under an Indenture for the debentures. Fidelity-Philadelphia Trust Company, prior to the exchanges, requested and received a ruling letter dated May 29, 1957 from the Treasury Department on the tax effects of the proposed exchanges. (R. 17-21) The request for the ruling had sought that all

of the exchanges should be treated as tax-free. The ruling letter, however, stated that although the exchange of the $3.00 par value common stock for the outstanding $1.00 par value common stock was a tax-free reorganization under Section 368(a)(1)(E) of the Code, the exchange of the debentures for the outstanding preferred stock was a redemption and therefore a taxable exchange under Section 302(a) of the Code. The pertinent portion of that ruling with respect to the exchange of the debentures for the outstanding preferred stock provided as follows:

> (3) Assuming but not determining that the 5% debenture bonds to be issued qualify as securities (create a genuine relationship of debtor and creditor), gain or loss will be recognized to the preferred stockholders from the exchange of 5% cumulative preferred stock, par $50., and the dividend arrearage thereon of $10. per share as of June 1, 1957, for debenture bonds and warrants to subscribe for the new common stock at $10. per share (section 302(a)). The gain or loss recognized from the exchange will be measured by the difference between the cost or other adjusted basis of the preferred stock surrendered and the fair market values of the debentures and warrants received and such gain or loss will constitute capital gain or loss subject to the applicable provisions and limitations of subchapter P Part I of Subtitle A of the Code.
>
> The basis of the debentures and warrants received by the holders of the old preferred stock will be the fair market values used in the determination of the recognizable gain or loss. (R. 20-21)

On the date of the exchange each share of preferred stock had a fair market value of $33.00. (R. 161, 167) The warrants were of negligible value. (R. 168)

The debentures differed materially from the preferred stock which was retired after the exchange. The debentures contained a specific maturity date and represented a binding, unconditional and legal obligation on the part of NAD to pay interest and principal. (R. 77, 154) Under the terms of the Indenture (R. 67) NAD was required to annually contribute a fixed amount to a sinking fund in order to redeem the debentures. (R. 100-102) The debentures were subordinated under the Indenture,

> only to current bank borrowings for inventory purposes which obligations mature by their original terms in less than twelve months and obligations of the Company [NAD] to suppliers of materials, services and labor incurred in the normal course of the Company's business and reasonably required in its operations, which obligations are due and payable when billed, and to any existing liens, encumbrances, mortgages, conditional sales agreements, or pledges, or any replacement, renewal, or extension thereof. . . . (R. 100)

and, unless the consent of the holders of at least 66⅔ percent of the debentures outstanding was obtained, the debentures could not be subordinated to any funded debt created, issued, assumed, or guaranteed by NAD or any subsidiary thereof. (R. 92-93)

The debentures and the underlying Indenture contained many other provisions for the protection of the priority of the debentures and the rights of the debentureholders. In part these included restrictions on the operations of NAD. (R. 93-95) The Indenture also set forth the debentureholders' remedies in the event that NAD defaulted on any of its obligations to pay interest or principal. (R. 108-117) In all respects the debentureholder was a

creditor of NAD rather than an owner which he had been when he held the preferred stock.[3]

In its income tax returns for the fiscal years ending April 30, 1958 through April 30, 1967, NAD claimed deductions for the additional interest paid by reason of amortizable original issue bond discount on the debentures which resulted from the difference between the face value of the debentures ($50.00) and the fair market value of the debentures on the date of issue ($33.00). (R. 27) Because the ruling letter (R. 17-21) required the fair market value of the preferred stock ($33.00) to be used in recognizing gain or loss to the preferred stockholders, NAD used that value ($33.00) in determining the fair market value of the debentures on the date of issue. The deductions for discount included both the amount amortized on a straight line basis spread over the 18 year prospective lives of the debentures as well as the unamortized discount on debentures repurchased or redeemed each year.[4] (R. 28) The deductions for the discount in the years 1958 through 1966 were included in loss carry-forwards to the fiscal year ended April 30, 1967. (R. 15-16)

The petitioner disallowed the interest deductions taken by NAD for the fiscal year ended April 30, 1967 in the amount of $109,804.00 and also disallowed $321,657.00 of interest deductions attributable to the fiscal years ending April 30, 1958 through April 30, 1966 as carried forward and deducted in the return for the year ended April 30,

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3. As a creditor of NAD the debentureholder was not an equity owner. He had no residual interest in the corporation or the profitability of the corporation. For financial statement purposes the debt owed him was reflected in the "Liability" section of the balance sheet while the residual interests of the stockholders were reflected in the "Owners' Equity" section of the balance sheet. (R. 157)

4. This straight line amortization of the discount resulted in additional interest on each debenture of $.95 per year or an additional 1.9% of interest per year. Effectively, NAD was paying 6.9% interest rather than the stated interest of 5%.

1967. The disallowance resulted in a deficiency which was assessed by petitioner. (R. 13-16) The deficiency was upheld by the United States Tax Court which, in its opinion (Pet. App. A 18-41), refused to follow the authoritative and binding decision of the Court of Appeals for the Tenth Circuit in *Atchison, Topeka and Santa Fe R. Co.* v. *United States*, 443 F.2d 147 (10th Cir. 1971). NAD appealed the decision of the Tax Court, and the Court of Appeals reversed the Tax Court (Pet. App. B 42-69) pointing out that the Tax Court had ignored the economic realities surrounding the exchange wherein the discount arose. The Court of Appeals in its opinion properly differentiated between what occurs in an exchange where gain or loss is recognized and what occurs in a transaction where discount arises. The Court of Appeals also explained the confusion apparent in several Court of Claims' decisions in which that Court had equated a loss with an interest expense.

SUMMARY OF ARGUMENT

I.

Code Section 163 providing for the deduction of interest expense and Treasury Regulation on Income Tax Section 1.61-12(c)(3) which permitted deductions of interest in the form of amortized bond discount were the primary guides for NAD in 1957 and up to and including 1967 for determining the propriety of NAD's bond discount deductions. These guides were silent on the subject of what constituted bond discount. However, the pertinent case law existing in 1957 and the economic realities of NAD's exchange of its debentures for its outstanding preferred stock clearly indicated that NAD incurred deductible bond discount in the exchange in the amount by which the total of the face amount of each debenture ($50.00) exceeded the issue price of the

debenture ($33.00). The $17.00 of discount represented part of the cost to NAD of using the preferred stockholder's $33.00 which was needed by NAD to purchase the preferred stock, a cost which NAD would not have incurred had it had $33.00 of ready cash to make the purchase.

II.

Interest expense or discount may be incurred by a taxpayer only in connection with debt obligations. Under virtually every possible standard established for determining whether a security is a debt obligation or an equity security as found in cases on the subject, NAD's debentures meet the criteria of debt obligations. After the 1957 exchange, the debentureholders were solely and exclusively creditors of NAD and they were not equity owners in NAD as they had been before the exchange when they were preferred stockholders. In contrast, the income debentures in *Erie Lackawanna R. R. Co.* v. *United States*, 422 F.2d 425 (Ct. Cl. 1970), relied upon by petitioner, appear to have been actually equity instruments nearly identical to the preferred stock for which they were exchanged.

III.

NAD's issuance of its debentures in the 1957 exchange constituted a redemption by NAD of the preferred stock under Code Sections 302, 311(a) and 317(b), and the exchange was not a tax-free recapitalization under Section 368(a)(1)(E). The ruling letter issued by the Treasury Department prior to the exchange specifically characterized the exchange of the debentures for the preferred stock as a redemption and not a tax-free recapitalization, and it required the parties to the exchange to recognize gain or loss on the exchange in accordance with the redemption sections. The redemption sections required the parties to the

exchange to accept the fair market value of the preferred stock on the date of the exchange ($33.00) as the issue price of the debentures.

IV.

The Court of Appeals properly recognized that to NAD the $17.00 difference between the face amount of the debentures and the issue price of the debentures represented interest expense in the form of discount and not a loss on the exchange. The Court of Claims, on the other hand, in the *Erie Lackawanna* case, *supra*, and those other cases relying on it has failed to recognize the distinction between gain or loss resulting from a redemption, an exchange transaction, and the interest expense incurred by a buyer, such as NAD, making a purchase without ready cash. The Court of Appeals' analogy of the NAD exchange to one where the corporation sold its $50.00 face amount debentures for $33.00 cash to obtain funds to redeem the outstanding preferred stock is appropriate not only as an analogy but because it clearly reflects the economic realities of the exchange which actually occurred. Among those economic realities were that the preferred stockholders acted as a "financing medium" in the exchange and that a $17.00 discount on a $50.00, 18 year 5 percent debenture resulted in an effective interest rate on the debenture of 6.9 percent or $3.45 annual interest, deductible to NAD and reportable as ordinary income by the debentureholder.

V.

The petitioner has adopted the Court of Claims' analysis in *Erie Lackawanna*, *supra*, and refers to that analysis as the "arithmetical equivalence" theory. NAD understands that phrase to mean that a debenture is the same as a share of preferred stock. However, in view of the many substantial distinctions between NAD's debentures and its preferred

stock, it appears that the use of the phrase "arithmetical equivalence" and the analysis it stands for, if applied to the case at bar, is merely an easy means of avoiding the task of analyzing the economic realities of the exchange and the totally distinct nature of the securities involved. Moreover, the weight to be accorded the decision in the *Erie Lackawanna* case must be minimal in view of its heavy reliance on *Union Pacific R.R.* v. *United States*, 401 F.2d 778 (Ct. Cl. 1969), cert. denied 395 U.S. 994 (1969) which was a case involving the application of the World War II excess profits tax provisions to a transaction wherein Union Pacific had issued common stock for outstanding convertible debentures, a situation bearing no resemblance to the facts in the case at bar.

ARGUMENT

I. The Applicable Code Section, Regulation and Case Law in Effect Between 1957 and 1967, When the Transaction Here Involved Occurred and the Interest Deductions Were Taken, Clearly Authorized NAD's Deductions for Amortized Original Issue Bond Discount.

In 1957 when the exchange transaction involved in this case took place, and during the period between 1958 and 1967, which coincides with that period of time when the interest deductions were taken by NAD, Section 163 of the Code and Section 1.61-12(c)(3) of the Treasury Regulations on Income Tax were the guides for taxpayers in determining the propriety of bond discount deductions.[5] Those sections provided in pertinent part as follows:

> Sec. 163. [Interest] (a) General Rule.—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.
>
> * * * *
>
> Income Tax Regulations Sec. 1.61-12 * * * *
>
> (c) * * * *
>
> (3) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. . . .
>
> * * * *

5. During the period 1957 to 1967, regulations under Section 163 with regard to bond discount were nonexistent. Reg. Section 1.61-12(c)(3) had been adopted in 1957 and subsequently was amended and reclassified under Section 163 in 1968. When the reclassification occurred in 1968 for the first time there was included a reference to Section 1232 regulations. This reference, however, is made only to adopt a definition as set forth in the Section 1232 regulations and does not adopt those regulations as a whole.

These provisions failed to adequately state the criteria for determining what constituted bond discount. However, the case law during this period and the economic realities involved in the issuance of debt securities, such as NAD issued, clearly dictated that the difference between the face value of a bond and the issue price of that bond represented bond discount.[6] In a non-cash exchange[7] such as NAD had, it was absolutely necessary to look to the economic facts surrounding the exchange transaction and analyze the economic realities of that situation in order to determine whether discount arose. The case law at the time stated that bond discount represented the expense of borrowing. It served "the same function as stated interest"[8] and "represents a part of the cost of the borrowed capital."[9] As set forth and aptly described in Judge (now Justice) Marshall's well reasoned opinion in *Nassau Lens Co.* v. *Commissioner*, 308 F.2d 39 (2d Cir. 1962), rev'g the United States Tax Court, 35 T.C. 268 (1960), a case decided subsequent to the 1957 exchange by NAD but long prior to 1967 when the deductions were disallowed by petitioner,

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6. NAD contends that even had Reg. Section 1.163-3(a) been in effect during the period in question, the same result, the deduction of amortized discount over the life of the debenture as interest expense, would have resulted. Section 1232 now controls the debentureholder's reporting of discount income, while Section 163 continues to control the deduction for the issuing corporation. The reference to Reg. Section 1.1232-3(b)(2) in Reg. Section 1.163-3(a) is limited to the adoption of the definition of bond discount as found in that provision. Therefore, any reference to Section 368 as found in Section 1232 is inapplicable to the issuing corporation, as is the bulk of Section 1232.

7. The problem of bond discount in exchanges of bonds for property was met head-on in *American Smelting and Refining Co.* v. *United States*, 130 F.2d 883 (3rd Cir. 1942). There the court held that discount did arise in such a transaction.

8. *United States* v. *Midland-Ross Corp.*, 381 U.S. 54, 57 (1965).

9. *Helvering* v. *Union Pacific R.R. Co.*, 293 U.S. 282, 287 (1934).

discount payments represent the cost of using someone else's money.

In the opinion in *Nassau Lens*, the Court stated:

> It may well be true that a 'borrowing buyer's' interest or discount payments seem part of the cost of property. In reality, however, they are the cost of using money which is needed to purchase the property, a cost not incurred by a buyer with ready cash. This distinction is clearly recognized by the code, and we feel that we must give effect to it . . . . The contention asserted [by the Commissioner] is merely that when a seller also becomes a financing medium by taking bonds issued at a discount instead of cash in exchange for property, the tax laws will not recognize a charge for the use of money. We find no support for such an assertion and reject it. *Id.* at 44.

Petitioner suggests in his brief[10] that the issue in this case is whether discount may arise in a financial reorganization, but, as the opinion in *Nassau Lens* indicates, the true issue is whether the preferred stockholders of NAD acted as a "financing medium" in the exchange and consequently the discount incurred by NAD on its debentures represented the excess expense incurred by NAD due to NAD's inability to pay cash to the preferred stockholders at the time of the exchange.[11] The majority opinion of the Court of Appeals clearly recognized this to be the issue in this case and decided that discount was incurred in the exchange and properly deducted by NAD.

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10. See Petitioner's Brief pp. 23-24.

11. The balance sheets for April 30, 1957 and 1958, as attached to the income tax return of NAD for the fiscal year ended April 30, 1958 (R. 30), clearly show that NAD did not have the necessary cash or other liquid assets to redeem the preferred stock, which was outstanding, in any manner other than by using the discounted debentures.

II. Discount and the Resulting Deduction for Interest Arise Only in Connection with Debt Obligations and Not in Connection with Equity Securities.

In every case involving a determination as to whether an interest deduction is appropriate, it is necessary to analyze the underlying security to determine if it is properly classified as a debt obligation.[12] The Supreme Court in analyzing the distinctions between debt and equity securities has held, in a case where debentures were issued for stock, that certain criteria may be utilized to determine if debentures are actually debt instruments. In *John Kelley Co.* v. *Commissioner*, 326 U.S. 521 (1946) this Court stated that debt securities reflect:

> . . . a promise to pay a certain annual amount, if earned, a priority for the debentures over common stock, . . . [assignability] without regard to any transfer of stock and a definite maturity date in the reasonable future. *Id.* at 526.

Basing its opinion on these given indicia of debt securities the Court found the obligations in question to be debt obligations upon which interest could properly be incurred and deducted by the issuing corporation.

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12. See *Lantz Co., Inc.* v. *United States*, 424 F.2d 1330 (9th Cir. 1970); *Gilbert* v. *Commissioner*, 262 F.2d 512 (2d Cir. 1959), cert. denied 359 U.S. 1002 (1959); and *Gordon Lubricating Co.*, 24 TCM 697 (1965). Recognizing the possible difficulties in distinguishing between debt and equity securities, Congress in 1969 authorized the Commissioner to issue regulations in this area. Section 385. Congress provided therein guidelines which the Commissioner could utilize. However, the Commissioner to this date has not issued proposed regulations.

NAD's debentures likewise are clearly debt obligations[13] having been issued in the form of 18 year, 5 percent, sinking fund debentures. The debentures carried an unconditional obligation on the part of NAD to pay interest. (R. 77, 154) The stated rate of interest for which NAD was liable was 5 percent. (R. 76, 77, 154) The stated interest was required by the terms of the debenture to be paid semi-annually. In the event the interest was not paid there was a default under the terms of the Indenture. (R. 108) In contrast the dividends on the previously outstanding

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13. The criteria for this determination are derived from *John Kelley Co.* v. *Commissioner, supra,* and later cases including *O. H. Krause Grain and Milling* v. *Commissioner,* 279 F.2d 123 (9th Cir. 1960), and *Gordon Lubricating Co., supra.* In *Gordon Lubricating Co., supra* note 12, at 710, the following determinative factors are set forth:

> (1) The form of the debentures, including a fixed reasonable date of maturity, interest rate, and an unqualified promise to pay both principal and interest.
>
> (2) Priority and nature of the claim in case of default in payment of interest and principal, including extent of subordination contemplated or provided for.
>
> (3) The capital structure of the corporation, especially as it relates to the type of business involved.
>
> (4) Provision for establishment of a sinking fund, and the extent to which the sinking fund is used to retire outstanding debt obligations.
>
> (5) The nature of the risk involved, and the possibility of repayment regardless of earnings and profits.
>
> (6) Whether debentures are issued pro rata to stockholders, and the degree of control in management available to debentureholders.
>
> (7) Whether outside lenders, who are not interested in the profits or increase in equity of the corporation, would loan money under similar circumstances.
>
> (8) The intent of the parties, and the reasons for issuing debentures.
>
> (9) Whether there was a business purpose for financing through the use of debentures rather than stock, or whether this form of investment was used primarily for tax avoidance purposes.

It is apparent from a review of these standards that NAD's debentures were debt obligations.

preferred stock, unlike interest, could legally be paid only if there existed earnings and profits.

There existed a fixed maturity date on the debentures in the reasonably near future as the debentures were to mature in 18 years or in 1975.[14]

The distinction between debt and equity securities has often been based on whether the holder thereof maintained a continuing interest in the corporation. NAD's debenture-holders lost all financial interest in the corporation in not more than 18 years, a relatively short period of time.[15]

The debentures were subordinated only to bank loans made for inventory purposes and to obligations of NAD to suppliers of materials, services and labor incurred in the normal course of business. (R. 100) Therefore, the preferred stock was replaced with a higher preference security in that NAD, unlike before the 1957 exchange, incurred a debt that it was unconditionally required to pay regardless of its earnings and profits. The assets of NAD backed the debentures. To the extent that there were creditors to which these debentures were not subordinated, and there

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14. As of this date all of the debentures have been retired.

15. This 18 year term of NAD's debentures contrasts with the 65 year income debentures found in *Erie Lackawanna R.R. Co.* v. *United States*, 422 F.2d 425 (Ct. Cl. 1970) relied upon by the petitioner and the dissenting judge in the Court of Appeals. NAD believes that the only way the result in *Erie* could be considered as proper is if the Court of Claims actually determined that the debentures there were not debt obligations but equity securities. The overly lengthy term of the debentures, the fact that their interest provisions paralleled the preferred stock dividend restrictions (the preferred stock carried a 5% annual dividend, cumulative to the extent of 15%, while the debentures carried a 5% interest rate, payable only if earned and cumulative to the extent of 15%. *Erie, Id.* at n.4) and the I.C.C.'s report indicating that the exchange made by Erie was done for the purpose of obtaining a reduction in Erie's income taxes (*Erie, Id.* at n.12) lead to the conclusion that the income debentures involved in *Erie* were actually equity instruments and that the exchange constituted a tax-free reorganization.

did exist such classes of creditors, and that there were assets available, the debentures were secured by the assets of NAD both as to payment of principal and interest until they were retired or redeemed. (R. 108)

The debentures and the Indenture required the establishment of a sinking fund to assure redemption of the debentures. The sinking fund was maintained by the trustee. NAD at all times met the requirements of the sinking fund and the debentures were retired on schedule. (R 28)

While many mechanical standards for determining whether an instrument is debt or equity exist,[16] the Second Circuit's standard in *Nassau Lens*[17] of "substantial economic reality" appears to be as good an approach as has been devised for making an appropriate determination.[18] The "economic realities" in this case are found in the fact that when the preferred stockholders became debenture holders they lost their voice in the corporate policy decisions and lost their residual interest in the corporation and its future profitability. They found themselves no longer subject to the risks which they had previously experienced as equity owners in NAD and they were guaranteed a return on their investment irrespective of current or accumulated earnings and profits. These factors when viewed as a whole make for a clear showing that the instruments issued were debt instruments on which original issue bond discount could and did arise.

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16. See note 13 of this Brief.

17. *Nassau Lens Co.* v. *Commissioner, supra.*

18. Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders* (3rd Ed. 1971) at 4-14, 4-15.

III. The Issuance of the Debentures in Exchange for the Preferred Stock Constituted a Redemption.

NAD believes that Congress clearly intended for an exchange such as occurred here of debentures for outstanding preferred stock to be treated as a redemption. The exchange entirely removed the preferred stockholders from their status as equity owners in the corporation.[19]

Section 317(b) of the Code defines a stock redemption as follows:

> . . . stock shall be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in an exchange for property. . . .

"Property" as used in Section 317(b) is defined in Section 317(a) as an all-inclusive item which excludes stock of the corporation making the distribution.[20] "Securities" such as debentures are specifically included as property. NAD clearly effected a redemption by acquiring its preferred stock in exchange for "property," its debentures, as described in Section 317(b).

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19. Under Section 302(a) a redemption occurs in cases such as this unless the distribution of the debentures is "essentially equivalent to a dividend." Cf. *Bazley* v. *Commissioner*, 331 U.S. 737 (1947). In *Bazley* the exchange of debentures for outstanding preferred stock in no way affected the preferred stockholder's equity interest in the corporation. The preferred stock and the common stock were both held proportionately by the same stockholders and therefore the exchange of the debentures for the preferred stock represented a redemption in form only, as the substance of the transaction was a dividend. The stockholder's equity interest in the corporation was unaltered by the exchange.

20. Section 317(a), Appendix A of this Brief p. 37.

Section 302[21] established the treatment which was to be accorded the preferred shareholders in the redemption. Section 302 provides that "exchange" treatment is to be accorded the stockholder where his equity interest is eliminated. Thus, the preferred stockholder was required to recognize gain or loss on the exchange. This treatment was affirmed by the Treasury's ruling issued to Fidelity-Philadelphia Trust Company prior to the exchange.[22]

Section 311(a)[23] dealing with the effect of a redemption on the issuing corporation provides that realized gain or loss to the corporation on the exchange is not to be recognized. The fact that a gain or loss is not "recognized" does not mean that it is not "realized" and that the value of the consideration given (the preferred stock worth $33 per share) is not to be equivalent to the value of that received in an arm's length transaction.[24] Furthermore, Section 311(a) does not provide that an *expense* such as discount cannot arise from an exchange transaction and subsequently be deducted.

The concepts of gains or losses and business expenses are totally severable and distinct concepts and are not to be confused as the petitioner and the Court of Claims, in its various decisions, have done.

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21. Section 302, Appendix A of this Brief p. 35.

22. R. 17-21.

23. Section 311(a), Appendix A of this Brief p. 37.

24. The exchange was a genuine arm's length transaction. The preferred shareholders no longer retained an equity interest nor a voice in NAD's operations. As a result they did not have an interest in the future profitability of NAD beyond that interest common to all creditors of NAD. Therefore, the opposing interests of the retiring stockholders and NAD resulted in an arm's length transaction. This factor was undoubtedly a consideration facing Congress when it extended a capital gain rather than ordinary income treatment to a section 302(a) redemption.

The petitioner contends that the exchange in this case was a reorganization and throughout his brief refers to it as a recapitalization. He attempts to analogize this case to those controlled by the reorganization provisions.[25] NAD believes these references only tend to cloud and confuse the issues. The petitioner at no point clarifies whether he is talking about a tax-free reorganization as described in Section 368(a)(1)(E) or a taxable financial reorganization. If he is referring to the latter it has no relevancy to a determination of the issues in this case nor does it aid in resolving those issues. If he is referring to the former he appears to be wrong as evidenced in great part by the conclusion in the Treasury's ruling letter issued prior to the exchange which stated that the exchange was a redemption and not a tax-free Section 368(a)(1)(E) recapitalization.[26]

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25. See Petitioner's Brief p. 16. Rev. Rul. 59-387, 1959-2 Cum. Bull. 56 involved the exchange of debentures and common stock for outstanding preferred stock. Consequently, the preferred stockholders retained an equity interest as common stockholders. In *Claussen's, Inc.* v. *United States*, 469 F.2d 340 (5th Cir. 1972), a case relied upon by petitioner, the outstanding common stock was exchanged for debentures plus the corporation's new common stock in direct proportion to the stockholder's original equity interest in the corporation. The Court of Appeals in the case at bar appropriately distinguished *Claussen's, Inc.* and in so doing stated:

> The court [in *Claussen's, Inc.*] held that the common stockholder's equitable posture relative to the corporation and to one another after the exchange was substantially the same as it was before the exchange, and hence no bond discount arose. Pet. App. B at 65 n.7.

26. A reorganization is described in Section 368 of the Code. Included in the definition of a reorganization is a recapitalization. Section 368(a)(1)(E). This term is not defined in the Code, and the accompanying regulations in defining a recapitalization (Reg. Section 1.368-2(e)) set forth several examples, all of which involve a corporation giving equity secur-

(Continued on following page)

In view of the fact that the exchange was determined to be a redemption the preferred stockholder was required to accept the fair market value of his preferred stock ($33.00) as representative of the fair market value of the debenture ($33.00).[27] Consequently, the preferred stockholder was required to report a gain or loss based on the difference between his basis in the preferred stock and the fair market value of the debenture ($33.00). He thereafter held the debenture with a basis equivalent to the fair market value of the debenture or $33.00 per debenture. (R. 21) Because the face amount of the debenture was $50.00 and the holder was to receive $50.00 at maturity, the $17.00 difference between the fair market value or issue price of the debenture and the $50.00 face amount represented interest income to the holder. Prior to 1969 this discount or interest income was recognized by the holder upon the maturity of the bond.[28] Since this treatment was proper for one party to this transaction, the preferred stockholder, it was likewise proper

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Footnote continued—

ities in the exchange. It is important to note that Reg. Section 1.354-1(d) suggests that when one is not within the terms of a reorganization in the exchange of debt for outstanding equity securities, then a redemption under Section 302 is involved. Reg. Section 1.354-(1)(d) ex. 3 states:

> C, a shareholder in Corporation Z . . ., surrenders all his stock in Corporation Z in exchange for securities in Corporation Z. . . . [S]ection 354 [that section which controls the tax treatment of a reorganization] does not apply. See, however, Section 302.

27. The Commissioner has criticized NAD for not having offered better evidence regarding the fair market value of the debentures. However, NAD has offered the best evidence possible. The debentures were not offered to the general public but were used to redeem the preferred stock trading in the over-the-counter market for $33.00 per share on the date of the exchange. (R. 160, 167)

28. Since 1969 the holder has been required to recognize discount ratably over the life of the bond. Section 1232(a)(3)(A).

that NAD should be viewed as having issued the debentures for the fair market value of the stock ($33.00), and that the difference between that fair market value and the face value should be amortizable interest expense and therefore deductible.[29]

The fact that NAD's exchange of the debentures for the preferred stock should be viewed as a redemption or "exchange" transaction finds further support in *Reef Corporation* v. *Commissioner*, 368 F.2d 125 (5th Cir. 1966), cert. denied 386 U.S. 1018 (1967). In the *Reef* case, the Court pointed out that in a tax-free recapitalization involving an exchange of common stock for common stock which was accomplished at the same time as an exchange of debentures for preferred stock, an additional separate event for tax purposes involving the exchange of the debentures for the preferred stock occurred. The Court there stated:

> to effect the intention of Congress manifested in the Code, we must separate this transaction into its two distinctly separate functional parts. The test of whether events should be viewed separately or together as part of a single plan is not temporal but is functional. See *Davant* v. *Commissioner of Internal Revenue*, 5 Cir. 1966, 366 F.2d 874. Applying this test to the instant case, it is clear that the redemption and the change of corporate vehicles must be viewed as separate and distinct events. Cf. *Bazley* v. *Commissioner of Internal Revenue*, 1947, 331 U.S. 737 . . . . *Id.* at 134.

This view clearly explains NAD's position in this case that the redemption was separate and distinct from the tax-free recapitalization of common-for-common which occurred. (R. 57)

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29. Reg. Section 1.61-12(c)(3), *supra*.

IV. NAD's Discount or Interest Expense of $17.00 Per Debenture Was Incurred Because of NAD's Need to Borrow $33.00 from the Preferred Stockholders in Order to Purchase Their Stock, and the $17.00 Was Not a Loss on the Exchange.

"Losses" and "interest deductions" are not synonymous concepts in the Internal Revenue Code. They are technical terms. Yet the petitioner argues that the use of the terms "loss" or "interest" presents an abstract or verbal issue.[30] Congress, on the other hand, has found it necessary to define interest expense deductions and gains and losses under separate subchapters of Subtitle A of the Internal Revenue Code.[31] Gains and losses result from sales wherein the appreciation or depreciation in value of property held for a period of time is recognized. An interest expense is best defined as "*compensation* for the use or forbearance of money."[32]

Judge Phillips, writing the opinion for the Court of Appeals, clearly recognized and explained the fact that "loss" and "interest expense in the form of discount" were separate elements in a transaction and he attempted to explain the confusion experienced by the Court of Claims in its cases.[33] He analogized the NAD situation to one where the corporation sold its $50.00 debentures for $33.00 to obtain the cash to redeem the outstanding preferred stock then selling for $33.00 per share. In turn this cash was used for a redemption of the outstanding preferred

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30. See Petitioner's Brief pp. 12-13.

31. Gains and losses are defined in Section 1001 of Subchapter O and are dealt with in other provisions of Subchapters O and P. Interest expense is a deduction defined and allowed in the computation of taxable income under subchapter B.

32. *United States* v. *Midland-Ross Corp.*, *supra*.

33. Pet. App. B 55-58.

stock, the corporation paying out $33.00 in cash per share to the preferred stockholders. This, said Judge Phillips, would undoubtedly result in a $17.00 discount. In his opinion to allow a deduction for discount in that situation and not in the case before the bar was to allow form to control over substance[34] and effectively deprived NAD of those deductions which Congress had intended should be granted under the Code.[35]

Judge Phillips' analysis of what took place was thorough and complete. He noted that a $17.00 discount on a $50.00, 18 year debenture resulted in only an additional 1.9 percent effective interest rate per year. This additional 1.9 percent was a reasonable addition to the 5 percent stated interest on the debentures, in light of the financial status of NAD at the date of the exchange. His analysis also made clear the distinctions between the concepts of gain or loss, on the one hand, and interest expense, on the other hand. Being able to separate these concepts, he found that interest expense could be incurred in the form of bond discount in an exchange resulting from a redemption where gain or loss might be realized.[36]

Other courts have also recognized that in an exchange of debt securities for stock or other debt securities original issue discount may arise, and these cases all clearly stand

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34. Pet. App. B 53-54.

35. To deny similarity in treatment of these two situations would result in a corporation embarking on an expensive set of transactions in order that it might clearly establish a deduction which Congress undoubtedly previously granted.

36. Gain or loss will be "realized" on most exchanges, however, it may or may not be "recognized." Realized gains and losses represent a concept separate from recognized gains and losses. See Sections 1001 and 1002.

for the proposition that discount is predominately a creature of economic fact.[37]

V. The Decisions and Analysis of the Court of Claims Relied upon by Petitioner Are Founded on Confusion and Erroneous Conclusions.

Erie Lackawanna R. R. Co. v. *United States, supra,* is the cornerstone of those cases supporting the petitioner's position herein as well as the petitioner's analysis of the exchange transaction. However, the Court in *Erie Lackawanna,* also relied upon by the dissent in the case at bar, fails to set forth any reasons for reaching the ultimate conclusion that:

> [s]ince plaintiff issued its stock for $100 per share and carried the stock on its books at this amount, this is the amount which should be used to determine whether discount has arisen. *Erie Lackawanna R. R. Co.* v. *United States, supra* note 15, at 429.

Apparently the conclusion is further reflected in the statement that plaintiff "lost nothing as a result of the transaction." *Erie Lackawanna R. R. Co.* v. *United States, supra* note 15, at 430.

The petitioner refers to these conclusions and the result reached by the Court of Claims as the "arithmetical equiva-

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37. *Atchison, Topeka and Santa Fe R. Co.* v. *United States,* 443 F.2d 147 (10th Cir. 1971) where the court at page 153 said it was necessary to look to "economic and business reality" to determine if discount arose; in *American Smelting and Refining Co.* v. *United States, supra* note 7, at 885 the court stated:

> We believe that discount is still to be treated as additional interest when the subject matter of the loan is stock instead of cash.

See *Nassau Lens Co.* v. *Commissioner, supra; Southern Fertilizer & Chemical Co.* v. *Edwards,* 167 F.Supp. 879 (M.D. Ga., 1955), and *Industrial Development Corp.* v. *U. S.,* 56-2 USTC, ¶10,066 (N.D. Ill., 1956).

lence" theory.[38] To point up the fallacy in such a theory let us assume that "A" buys a machine for $55.00 in 1960 and sells it to "B" in 1965 for $50.00 cash. In 1970 "A" repurchases the same machine from "B" for a $45.00 note with an additional $5.00 interest to be paid. "A" has regained his machinery and he will pay "B" a total of $50.00, the same amount or arithmetical equivalent of what "B" paid "A" five years earlier. However, the economic realities and the surrounding facts, i.e., the cost of the use of "B's" money and the decline in the market value of the machine, point up the fact that an arithmetical equivalence formula is an approach used only when one fails to make an analysis of a transaction and the economic realities attached thereto.

The basic fallacy inherent in the reasoning of both the Court of Claims and petitioner is that they fail to distinguish between a debt obligation, which is reflected as a long term liability on the books of the corporation, and an equity interest which is reflected in a capital account of the corporation. From the accounting viewpoint a corporation's capital accounts are those representing contributed or paid-in capital. The capital accounts do not include borrowed funds which the corporation must repay at a fixed maturity date, with set sums of interest to be paid at regular intervals prior to maturity.[39]

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38. Such a phrase is difficult to comprehend but we assume in the context of the facts of the case at hand that it means something like an apple equals an orange, or a debenture equals a share of preferred stock. But, in truth we believe this approach is employed as an easy means of avoiding the otherwise difficult task of analyzing the economic realities of a given case and recognizing the tax consequences involved in a transaction.

39. See generally Section 21 of Wilcox, Kell and Bedford, *Accountant's Handbook* (5th ed. 1970), p. 21.1.

The confusion apparent in the *Erie Lackawanna* case is further compounded by a proper reading of the *Union Pacific* case[40] which the Court of Claims relied upon so heavily in arriving at its decision in *Erie Lackawanna*. The *Union Pacific* fact situation was the converse of that in *Erie Lackawanna* and the tax involved was the World War II excess profits tax. In *Union Pacific*, the taxpayer corporation substituted common stock for its outstanding convertible debentures.[41] The value of the debenture in the hands of its holder constituted a liability to the issuer taxpayer corporation in the face amount of the debenture. The corporation would some day have to pay this face amount in full. Therefore, the exchange of common stock for the outstanding debentures constituted a satisfaction of the debt in its face amount. This is not analogous to the converse situation before this Court where NAD had outstanding preferred stock with a $50.00 par value which it never would have been required to repay.

It should be noted that the *Union Pacific* case, *infra* note 40, involved convertible debentures. The issuance of a convertible debenture does not yield a closed transaction because from the date of issuance of the debenture to the date of conversion the holder has the option to convert the debenture into stock. Thus, it might be proper to tie the issuance of the convertible debenture to the subsequent conversion into stock and treat it as one transaction as the conversion was clearly anticipated when the debentures were originally issued. The Court in *Union Pacific* felt that for this reason the value of the stock was

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40. *Union Pacific R.R. v. United States*, 401 F.2d 778 (Ct. Cl. 1969), cert. denied 395 U.S. 994 (1969).

41. Reg. Section 1.368-2(e)(1) indicates that this form of a transaction is a recapitalization which will constitute a reorganization.

equivalent to the face amount of the debentures. This was probably true, but NAD's transaction was entirely different.

The petitioner, relying on the decision in *Erie Lackawanna*, has attempted to treat the sequence of events in NAD's transaction as one. He has argued that the $50.00 received by NAD in 1946 should be viewed as the same $50.00 ultimately received by the debentureholder at the maturity date.[42] He totally ignores the $33.00 market value of the preferred stock on the date of the exchange. Such an approach is interesting because it is certain that had the preferred stock had a fair market value of $60.00 as of the date of the exchange the preferred stockholder would not have accepted the $50.00 face amount debenture. In any event, the sale of stock is generally considered to be a closed transaction as is the redemption of stock. Therefore, the petitioner's contention that each of these transactions should be treated as part of a continuing series of transactions is without statutory or factual support. An analysis of the events shows that they are separate and should be viewed as such.

In 1946 and subsequent years NAD issued preferred stock for cash or similar property. The par value of this stock was recorded on the books of NAD in a stockholders' equity account the preferred stock account. In 1957 NAD issued debentures in the face amount of $50.00 for each share of preferred stock then outstanding and trading for $33.00 per share. It was financially impossible for NAD to use cash to redeem this stock.[43] Due to the poor financial condition of NAD and the risk involved in accepting NAD's debentures it was unlikely that the preferred stockholders would accept debt obligations equal

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42. See Petitioner's Brief p. 28.

43. See note 11 of this Brief.

to the $33.00 fair market value of the preferred stock and paying a mere 5 percent interest rate. To resolve this situation, NAD was willing to pay additional interest in the form of discount on the debentures. The economic realities of the situation had to be recognized. While the preferred stockholders might have accepted $33.00 cash in hand for their stock, they would not have reloaned that money to NAD without requiring NAD to pay for the use of the money, particularly in view of NAD's financial status at that time.[44] Therefore, the extra $17.00, the difference between the face amount of the debenture and the fair market value or issue price of $33.00, was an additional cost which NAD paid for the use of the funds.

The petitioner has cited *Old Mission Co.* v. *Helvering*, 293 U.S. 289, 292-293 (1934)[45] for the proposition that where bonds are issued by one corporation and held by an affiliate with which it files a consolidated return no deductible interest expense or discount attributable to those bonds can arise. The actual basis for the decision in *Old Mission* was that the discount or interest could not be deducted in view of the fact that the affiliate would not have had to recognize the discount or interest as income until the maturity date of the bonds while the issuer of the bonds would have been deducting the interest expense or discount over the life of the bonds thereby creating an unwarranted interest deduction between affiliates. NAD fails to see the significance of this case as it relates to the issues in the case at hand.

Another case inappropriately cited by the Commissoner is *Great Western Power Co.* v. *Commissioner*, 297 U.S. 543 (1936). The Commissioner contends that this

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44. See note 11 of this Brief.

45. See Petitioner's Brief p. 13.

case is a bald rejection by the Supreme Court of the "contrary to fact analysis" made by Judge Phillips in the decision of the Court of Appeals.[46] Judge Phillips felt that the true substance of the case could best be viewed when a realistic economic analysis of the facts surrounding the exchange was made. The *Great Western* case involved an exchange of bonds for bonds. The question presented was *when* the issuer could deduct the expense incurred. The accrual basis taxpayer corporation argued that if the Court viewed the exchange as having been made with cash then the expense was deductible currently. The Court, however, said that in determining *when* the expenses were deductible one could not use a cash substitution test and that in this case the taxpayer corporation had to amortize and deduct the expense over the life of the bonds. The issues in *Great Western* are not similar to those in the case at hand. In the case at bar the question is not *when* the expense is to be deducted but rather whether interest expense was incurred. Moreover, it is not a question of timing or cash basis accounting versus accrual basis accounting as it was in the *Great Western* case.

The petitioner quotes *Penfield* v. *Davis*, 105 F.Supp. 292, 311 (N.D. Ala., 1952), affirmed, 205 F.2d 798 (5th Cir. 1953), stating that "from the standpoint of the preferred shareholders, the conclusion appears inescapable that their interest 'was fairly reflected in the highly equivalent characteristics of the debentures into which the preferred [stock] was converted.'"[47] Yet the petitioner fails to recognize that under the 1939 Internal Revenue Code, which controlled the *Penfield* case, there did not exist a provision which specifically stated that the exchange of

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46. See Petitioner's Brief p. 27.

47. See Petitioner's Brief p. 15.

debt securities for outstanding equity securities was a redemption such as now exist in Sections 317(a) and (b) and 302 of the 1954 Code. Prior to the adoption of these sections the courts were without guidelines for determining what constituted a redemption as opposed to a reorganization. As a result, cases such as *Penfield* caused confusion, as the courts attempted to determine how the situation should be handled. The 1954 Code made massive changes in this area, clearing up the confusion which existed, as explained in *Reef Corporation* v. *Commissioner, supra* p. 22, at 134-135 where it is stated:

> In 1954 Congress completely overhauled the sections of the Code detailing the tax consequences of many types of corporate transactions. Grouped together by Congress were the sections dealing with corporate distributions and adjustments, including the sections dealing with partial liquidations, stock redemptions (complete or partial), and corporate reorganizations. As we said in *Davant* v. *Commissioner of Internal Revenue*, 5 Cir. 1966, 366 F.2d 874 at 879: 'In order to effectuate the intent of Congress the dividend, liquidation, redemption and reorganization sections of the Code must be examined and viewed as a functional whole.'
>
> Prior to 1954 Congress had not specifically provided for the tax treatment of partial liquidations or redemptions. This problem had been handled by judicial decisions which caused 'unwarranted' taxes and in others allowed taxpayers to 'avoid' proper taxation. To correct this situation, Congress enacted a comprehensive set of rules governing the complete and partial redemptions of a stockholder's interest in a corporation. Section 302.

> In the instant case the only way to protect the statutory intent of Congress is to test the redemption of stock by the provisions of section 302. A similar result as to the stockholders comes from applying sections 368, 354 and 356. But this method may not always reach the same result and in the instant case would cause an improper result with regard to the corporation. Since the reorganization and the redemption are functionally unrelated in this case, the redemption should be tested by the standard Congress has laid down in section 302.

A test of the facts surrounding NAD's transaction against the standard of Section 302 shows that a redemption occurred and that the preferred stockholders were required to use the fair market values for the debentures and preferred stock in recognizing gain or loss. If the stockholder in the exchange is required to use fair market value, NAD should also.[48] It appears to NAD that the petitioner wishes to completely avoid discussion of a redemption in his brief in an attempt to reinstate the pre-1954 Code decisions even though Congress specifically legislated in this field to clear up the confusion existing under the 1939 Code as reflected in cases such as *Penfield*.

Similarly, petitioner contends that *Helvering* v. *Southwest Corp.*, 315 U.S. 194 (1942) requires the present case to be viewed as a reorganization.[49] As has just been noted, however, the 1954 Code introduced new concepts in the area of corporate redemptions and *Southwest Corp.* is another case decided prior to Congress' introduction of these concepts in the 1954 Code. Further, and as pointed out previously, the term "capital structure" in an accounting

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48. See p. 21 of this Brief.

49. See Petitioner's Brief p. 24.

sense does not include long term liabilities but rather includes only contributed capital of the equity owners.[50] Therefore, the reference in *Southwest Corp.* to a "reshuffling of the capital structure", which petitioner attempts to attribute to NAD's transaction, is inappropriate since a redemption of a portion of the capital structure with debt obligations cannot be included in such a phrase.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the judgment of the Court of Appeals should be affirmed.

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50. See p. 26 of this Brief.

CERTIFICATE OF SERVICE

I certify that on the 27th day of December, 1973, three copies of the above and foregoing Brief for the Respondent were sent postage prepaid, by regular United States mail in accordance with Rule 33 of the Rules of the Supreme Court of the United States, to the Honorable Robert H. Bork, Solicitor General, and Stuart A. Smith, Assistant to the Solicitor General, Department of Justice, Washington, D.C. 20530, and one copy each was similarly sent to Scott P. Crampton, Assistant Attorney General, and Meyer Rothwacks and Ernest J. Brown, Attorneys, Tax Division, Department of Justice, Washington, D.C.

.....

Attorney for Respondent

APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

Sec. 163. [INTEREST.] (a) General Rule.—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

* * * *

Sec. 302. DISTRIBUTIONS IN REDEMPTION OF STOCK.

(a) General rule—If a corporation redeems its stock (within the meaning of Section 317(b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.

(b) Redemptions Treated as Exchanges—

(1) Redemptions Not Equivalent to Dividends —Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.

(2) Substantially Disproportionate Redemption of Stock—

(A) In General—Subsection (a) shall apply if the distribution is substantially disproportionate with respect to the shareholder.

(B) Limitation—This paragraph shall not apply unless immediately after the redemption the shareholder owns less than 50 percent of the total combined voting power of all classes of stock entitled to vote.

(C) Definitions—For purposes of this paragraph, the distribution is substantially disproportionate if—

(i) the ratio which the voting stock of the corporation owned by the shareholder immediately after the redemption bears to all of the voting stock of the corporation at such time,

is less than 80 percent of—

(ii) the ratio which the voting stock of the corporation owned by the shareholder immediately before the redemption bears to all of the voting stock of the corporation at such time.

For purposes of this paragraph, no distribution shall be treated as substantially disproportionate unless the shareholder's ownership of the common stock of the corporation (whether voting or nonvoting) after and before redemption also meets the 80 percent requirement of the preceding sentence. For purposes of the preceding sentence, if there is more than one class of common stock, the determinations shall be made by reference to fair market value.

(D) Series of Redemptions—This paragraph shall not apply to any redemption made pursuant to a plan the purpose or effect of which is a series of redemptions resulting in a distribution which (in the aggregate) is not substantially disproportionate with respect to the shareholder.

(3) Termination of Shareholder's Interest—Subsection (a) shall apply if the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder.

* * * *

Sec. 311. TAXABILITY OF CORPORATION ON DISTRIBUTION.

(a) General Rule—Except as provided in subsections (b), (c), and (d) of this section and Section 453(d), no gain or loss shall be recognized to a corporation on the distribution, with respect to its stock of—

(1) Its stock (or rights to acquire its stock), or

(2) Property.

* * * *

Sec. 317. OTHER DEFINITIONS.

(a) Property—For purposes of this part, the term "property" means money, securities, and any other property; except that such term does not include stock in the corporation making the distribution (or rights to acquire such stock).

(b) Redemption of Stock—For purposes of this part, stock shall be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock.

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

Sec. 1.61-12 [as republished in T.D. 6500, 25 Fed. Reg., Part 11, pp. 11402, 11442-11443] Income from Discharge of Indebtedness.

* * * *

(c) Sale and Purchase by Corporation of its Bonds. . . .

* * * *

(3) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds.

* * * *

DEC 28 1973

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1973

No. 73-9

COMMISSIONER OF INTERNAL REVENUE,

Petitioner

v.

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY,

Respondent

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

AMICUS CURIAE BRIEF ON BEHALF OF ST. LOUIS SAN FRANCISCO RAILWAY COMPANY; MISSOURI PACIFIC RAILROAD COMPANY, AND GULF, MOBILE & OHIO RAILWAY COMPANY

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Pursuant to Rule 42 of the Supreme Court's Rules and the consent (Appendix A and B) of each of the primary parties, this amicus brief is hereby filed in support of the position, relating to debt discount, as set forth and upheld in the decision of the United States Court of Appeals for the Tenth Circuit in *National Alfalfa Dehydrating and Milling Company v. Commissioner*, 472

F.2d 796 (1973). Each of the above-listed amici curiae, St. Louis San Francisco Railway Company (Frisco), Missouri Pacific Railroad Company (Mo. Pac.) and Gulf, Mobile & Ohio Railway Company (GM&O), have quite similar debt discount issues to that involved in the *National Alfalfa* case pending in various jurisdictions, including this Court.[1]

OPINIONS BELOW

The opinions below, which are submitted for consideration, may be found in the Appendix as follows:

(1) *National Alfalfa Dehydrating and Milling Company v. Commissioner*, (CA-10, 1973), 472 F.2d 796 (Appendix C).

(2) *St. Louis San Francisco Railway Company v. United States* (Ct. Cls., 1971), 444 F.2d 1102, cert. denied 405 U.S. 1017,(Appendix D).

(3) *Missouri Pacific Railroad Company v. United States* (Ct. Cls., 1970), 427 F.2d 727, cert. denied 402 U.S. 904, (Appendix E).

(4) *Gulf, Mobile & Ohio Railway Company v. United States* (U.S. Dist. Ct., Ala., 1972), 339 F.Supp. 489, and U.S. Dist. Ct., Ala., 31 AFTR2d 73-348 decided 1/12/73 (Appendix F and G).

JURISDICTION

The petition was filed on June 25, 1973 and certiorari was granted on October 9, 1973. The jurisdiction of this Court rests on 28 U.S.C. 1255(1).

[1] A petition for certiorari (Docket No. 72-1245) was filed with this Court on March 12, 1973, in *St. Louis San Francisco Railway Company v. United States*, 470 F.2d 523. That petition remains pending.

QUESTIONS PRESENTED

1. When a corporation issues debentures in exchange for its preferred stock having a market value less than the face amount of the debentures, does the difference between the market value of the preferred stock and the face amount of the debentures constitute additional interest amortizable over the life of the debentures.

2. When a corporation issues new bonds in exchange for its old bonds having a market value less than the face amount of the new bonds, does the difference between the market value of the old bonds and the face amount of the new bonds constitute additional interest amortizable over the life of the new bonds.

3. Whether any portion of the amortizable debt discount and expense attributable to outstanding debt securities may be carried over and amortized over the life of the new debt securities issued in exchange therefor in a reorganization of a corporation involving the issuance of new stock and debt securities for the previously outstanding debt securities.

STATUTES INVOLVED

The statutory provisions involved are Section 163 of the Internal Revenue Code of 1954 (26 U.S.C. Section 163) and Income Tax Regulations 1.163-3 promulgated by the United States Treasury. These sections are printed in Appendix H and I.

STATEMENT

The facts pertaining to each of the amici, which are parties to this brief, are closely related to the facts of the present respondent (Alfalfa) in this proceeding and are set forth separately below:

A. St. Louis San Francisco Railway Company

Amicus (Frisco) is a corporation organized and existing under the laws of the State of Missouri, and has its principal offices in St. Louis. At all times here pertinent, Frisco was engaged in operating as a common carrier by rail in interstate commerce and employed the accrual method of accounting.

1. In 1956, Frisco exchanged Series A, 5% Income Debentures bearing a maturity date of January 1, 2006, plus cash and common stock for a part of its outstanding Series A, 5% Preferred Stocks, issued in its 1947 reorganization. The Internal Revenue Service ruled that this exchange was a reorganization under Section 368(a)(1)(E) of the Internal Revenue Code of 1954. It also ruled that gain, if any, was recognizable to the exchanging preferred stockholders measured by the excess of the aggregate fair market value of the securities and cash received over the tax basis of the preferred stock surrendered. For each $100 par value share of preferred stock surrendered, the holders of the preferred stock received a $100 maturity value Series A Debenture and one quarter share of common stock. They also received $5.00 cash for the dividends on the preferred stock which would have been due at the next dividend payment date had the preferred stockholder not surrendered his stock. In the aggregate, Frisco issued new debentures having a face value of $33,129,000, 82,823 shares of no par value common stock and cash in exchange for 331,290 shares preferred stock, a total par value of $33,129,000 but a market value, based upon New York Stock Exchange quotations, of $22,908,148.35. Frisco contends that, based upon the legal principles enunciated by the Tenth Circuit Court of Appeals in *National Alfalfa*, it should be entitled to amortize as additional interest the difference between the maturity value ($33,129,000) of new de-

bentures issued and the fair market value of the preferred stock ($22,908,148.35) received in exchange for the new debentures as debt discount, and in any event, that it sustained debt discount upon the exchange to the extent of the value of the common stock and cash given up in the exchange.

The Court below (Court of Claims) held in the *Frisco* case, supra, that Frisco was not entitled to amortize the difference between the maturity value of the new debt securities and the fair market value of the preferred stock nor did Frisco sustain debt discount to the extent of the value of the common stock given up in the exchange. In support of its decision in the Frisco case, the lower court relied upon its prior decisions in *Erie Lackawanna Railroad Company v. United States*, 422 F.2d 425 (Ct. Cl., 1970), and *Missouri Pacific Railroad v. United States*, 427 F.2d 727 (Ct. Cl., 1970), modified on reconsideration, 433 F.2d 1324 (1970), cert. denied, 402 U.S. 944 (1971).

2. Frisco was reorganized, effective January 1, 1947, pursuant to a plan of reorganization approved by the Inter-state Commerce Commission and the Federal District Court having jurisdiction over Frisco's trusteeship under Section 77 of the Federal Bankruptcy Act, 11 U.S.C. Section 205 (1964). Under the reorganization plan, the outstanding common and preferred stock and the claims of unsecured creditors were eliminated as worthless and the holders of the several classes of long-term indebtedness and the bank creditors received new bonds, preferred stock, common stock and cash. As part of such plan, Frisco issued new 4% First Mortgage Bonds and 4½% Second Mortgage Bonds having an aggregate maturity value of $120,935,000 but a market value, established by the New York Stock Exchange quotation, totaling $91,866,411 in exchange for the

outstanding old secured debt. Frisco contends that it is entitled to amortize the difference of $29,068,589 between the maturity value of the new bonds and the fair market value of the old bonds as additional interest over the life of the new securities.

The Court below held that the difference between the maturity value of the new bonds and the fair market value of the old bonds did not constitute additional interest amortizable over the life of the new bonds "because the maturity value of the new debt did not exceed the maturity value of the old debt". The Court cited its *Erie Lackawanna* and *Missouri Pacific* decisions, supra, in support of its opinion.

3. In 1947, Frisco underwent a reorganization pursuant to Section 77 of the Bankruptcy Act. Under the approval plan as finally adopted by the ICC and the Courts, Frisco exchanged new bonds, new stock and cash for old debt securities, stock, bank loans and accrued interest. At the time of such reorganization (January 1, 1947), Frisco had an old extant debt on which there remained unamortized debt discount and issuance expense as follows:

Debt Security	Unamortized Debt Discount And Expense
Prior Lien 4% Bonds, Series A	$ 224,903.00
Prior Lien 5% Bonds, Series B	2,214.00
Consolidated 4½% Bonds, Series A	4,182,322.00
Consolidated 6% Bonds, Series B	8.33
Total	$ 4,409,447.33

All of the above-listed debt had been issued by Frisco between 1916 and 1947 for cash. For example, in 1928, the ICC, by Finance Docket No. 6798-1928, 138 ICC 505, granted Frisco authority to sell $108,000,000 of its

Consolidated 4½% Bonds, Series A, at a discounted price of 94½; and such sale was duly consummated, with the result that Frisco suffered actual cash discount in excess of $4,000,000.

In the course of the audit of Frisco's income tax returns for the years immediately following its 1947 reorganization, the Internal Revenue Service allocated the pre-reorganization unamortized discount to interest, the new common stock and debt securities. Such allocation was made by determining the percentage of new bonds issued in exchange for interest, common stock, preferred stock and the old debt securities and applying the percentages to the total unamortized discount. The amounts allocated to the new debt securities were as follows:

New Debt Securities	Old Unamortized Discount and Expense Allocated
4% First Mortgage Bonds	$ 969,605.41
4½% Second Mortgage Bonds	684,005.41
Total	$1,653,610.82

The Internal Revenue Service allowed Frisco's deductions for amortization of the allocated carryover discount for the years 1947 through 1965. The balance of such carryover discount, deemed to be attributable to interest and the stock in the 1947 reorganization, was "washed out" and no deductions have ever been claimed or allowed with respect thereto.

In the Court below, the Government asserted as an offset that the amortization deduction for the years 1953 through 1962 were improperly allowed and the Court sustained the Government's contention on the ground that the issue was governed by its decision in *Chicago, Milwaukee, St. Paul and Pacific Railroad v. United States*, 404 F.2d 960 (1968).

B. Missouri Pacific Railroad Company

Missouri Pacific Railroad Company (MP), is a corporation organized and existing under the laws of the State of Missouri and has its principal offices in St. Louis. At all times here pertinent, MP was engaged in operating a common carrier by rail in interstate commerce and employed the accrual method of accounting.

MP, along with its subsidiaries, was organized, effective March 1, 1956, pursuant to a plan of reorganization approved by the Interstate Commerce Commission and the Federal District Court having jurisdiction over MP's trusteeship under Section 77 of the Federal Bankruptcy Act, 11 U.S.C. Section 205 (1964). Under this reorganization plan, MP issued its new Collateral Trust Notes, First Mortgage 4¼% Bonds, Series A and B, 5% 90-Year Debentures and stock in exchange for its previously outstanding debt securities and stock and securities of its subsidiaries, which were merged with MP as a part of said reorganization proceedings. In accordance with said plan and consummation order, upon consummation of the reorganization, the old outstanding debt and stock were retired and cancelled.

The aggregate maturity value of the new Collateral Trust Notes, First Mortgage 4¼% Bonds, Series B and C, General Mortgage Income 4¾% Bonds, Series A and B, and the 5% 90-Year Debentures issued under the reorganization plan was $529,117,141.00. The fair market value of the old securities and stock of MP and its subsidiaries, for which the new securities were issued, was $452,151,252.00 on the date of exchange. The difference between the maturity value of the new securities and the fair market value of the old was $76,965,889.00. MP amortized this difference over the life of the new securities and claimed debt discount (additional interest)

deduction of $1,027,372.00 for 1957, $1,023,325.00 for 1958, $1,018,760.00 for 1959, $1,019,453.00 for 1960 and $905,650.00 for 1961. The Court of Claims denied such deductions.

C. Gulf, Mobile and Ohio Railroad Company

Amicus GM&O at all times here pertinent was a corporation organized and existing under the laws of the State of Mississippi and was engaged in operating as a common carrier by rail in interstate commerce and employed the accrual method of accounting.

1. In 1957, the GM&O applied for and received permission from the Interstate Commerce Commission (ICC) to issue 5% income debentures, Series A, due December 1, 2056, in the principal amount not to exceed $28,343,800 in exchange for up to 283,438¼ shares of its issued and outstanding preferred stock, without par value, $5.00 series, having a stated value of $100 per share. Pursuant to that authority GM&O during the period December 31, 1957, through December 31, 1962, issued a total of 187,116 income debentures in exchange for a like number of shares of preferred stock.

The exchange was a taxable exchange to those holders of the preferred stock who exchanged their shares for the income debentures. During the exchange offer, GM&O's preferred stock was listed on the New York Stock Exchange. GM&O claimed a deduction for amortizable debt discount arising from the exchange of its income debentures for its preferred stock by taking the total principal amount ($18,711,600) of the income debentures issued and subtracting therefrom the total fair market value ($11,869,092.44) of the preferred stock, received in exchange for the income debentures, as determined by the listing price on the New York Stock

Exchange. The resulting difference of $6,842,507.56 was claimed by the GM&O as the total discount arising from the exchange, which amount it claimed was amortizable over the 100 year life of the income debentures.

The Court below (District Court for the Southern District of Alabama) held that the exchange by the GM&O of its income debentures for its outstanding preferred stock was more than a reshuffling of its assets and that a very basic transformation had occurred in the capital structure of the corporation. A creditor, with full rights, had been substituted for what had previously been one with an owner interest in the company. The Court held that debt discount had occurred measured by the difference between the issue price originally received by the GM&O for the preferred stock and par value of the bonds, except if the fair market value of the preferred stock at the time of the exchange was greater than the issue price, then the debt discount would be the difference between the fair market value of the preferred stock and the par value of the bonds, provided, however, that no debt discount would exist if either the issue price or the fair market value of the preferred stock exceeds the par value of the bonds. The Court ordered a new hearing to determine the issue price of the preferred stock.

2. Upon rehearing, evidence was introduced that the preferred stock had been issued by the GM&O in 1940 as a result of a plan or reorganization arising out of the bankruptcy reorganization of the Mobile and Ohio Railroad Company. Under the plan of reorganization, the properties of the Gulf, Mobile and Northern Railroad Company (hereinafter the "GM&N") and the New Orleans Great Northern Railroad (hereinafter the "NOGN"), a leased railroad, and the bankrupt Mobile

and Ohio Railroad Company (hereinafter the "M&O") were unified into a new company. Pursuant to the plan, the GM&O was incorporated in November, 1938, and it issued bonds, preferred stock and common stock in exchange for the outstanding securities of the M&O which were allowed to participate in the reorganization, for the outstanding preferred and common stock of the GM&N and for the outstanding common stock and income debentures of the NOGN. The Court below found that upon issuance of the preferred stock in 1940, the GM&O received substantially less than the then fair market value of the preferred stock on the dates of the exchange (approximately $70 per share during 1957 through 1962).

3. In determining the fair market value of the preferred stock issued by the GM&O in exchange for its income debentures during 1957 through 1962, the Court below refused to look solely to the market prices of GM&O's preferred stock as reflected on the New York Stock Exchange. Expert testimony was introduced concerning the fair market value of the stock and the Court below, as the trier of facts, determined that the fair market value of the preferred stock to the GM&O was $80.00 per share. In determining this value, the Court below gave consideration to the fact that as a result of the exchange GM&O acquired an income tax deduction for the interest it paid on the income debentures while no deduction was allowed for the dividends paid on the preferred stock.

SUMMARY OF ARGUMENT

(A)

It is now universally accepted that debt discount is additional interest paid or to be paid for the borrowing of

funds. In all the cases involved in this proceeding, the courts have treated debt discount as additional interest, paid over and above stated interest, for the use or forebearance of money (*Deputy v. DuPont*, 308 U.S. 488, 498 (1940); *United States v. Midland-Ross Corp.*, 381 U.S. 54). Petitioner, in its brief (p. 6-7) to this Court in *National Alfalfa*, supra, states that ". . . the Court has been explicit in recognizing discount as serving the function of interest, and the current Regulations treat it under Section 163, which allows a deduction for interest paid or accrued".

(B)

Debt discount, being interest, constitutes one of the costs of acquiring and retaining the use of borrowed funds. It follows that what a debtor does with the assets acquired by the issuance of debt and what its adjusted tax basis, for such assets so acquired, may be for gain or loss purposes have completely independent tax consequences from any discount that may be sustained by reason of the issuance of debt. Gain or loss under the Internal Revenue Code are terms of art directly related to tax basis of property and the disposition thereof but have no relationship with debt discount or interest expense incurred for the use of borrowed funds.

(C)

Once debt discount has been appropriately characterized as interest, it is imperative that the proper method of measuring debt discount be prescribed. Contrary to the decisions of the Court of Claims, and correctly so, the United States Court of Appeals for the Tenth Circuit, in *National Alfalfa*, supra, held that debt discount represented the difference between the face amount of the

debt issued and the market value of the preferred stock as of the time of its exchange for such debt. The position adopted by that court is wholly consistent with long-established Internal Revenue Service rules and court decisions for determining the value of securities (cf., Interal Revenue Code, 26 U.S.C. Section 2031 (1964), Treas. Regs., Section 20.2031-2(b) and 25.2512-2(b)).

(D)

Petitioner, in its *National Alfalfa* brief, at pages 8 and 9, contends that no bond discount could arise where a $50 debenture is issued in exchange for $50 par value preferred stock on the basis of arithmetical equivalence. That contention completely ignors the realistic pressures of the money market at the time debt securities are issued. The payment of a discount or the issuance of securities in a face amount or maturity value greater than the securities received in exchange is an absolute necessity and inducement where the interest rate called for in the bond is less than the going rate for the use of money in effect at the time of issuance.

Petitioner at page 9 of its brief states that it seeks reversal of the Circuit Court of Appeals decision in *National Alfalfa* on the broader ground that the substitution of one security for another does not produce deductible bond discount. The law, even in its present state, relating to debt discount does not support petitioner's proposition. In addition, that proposal is contrary to the intent and purpose of the amendment to Section 1232(b)(2) of the 1954 Internal Revenue Code, enacted by Congress as Section 413 of the Tax Reform Act of 1969, which provides that debt discount can arise where debt is issued for stock or other property and that such discount is measured by the difference between the

maturity value of the debt and the fair market value of the property received in exchange therefor.

Under the circumstances of this proceeding, the Court of Appeals' decision in *National Alfalfa* should be affirmed and the Court of Claims' decision relating to debt discount should be reversed as erroneous and not in accord with the law.

ARGUMENT

I.

RESPONDENT, NATIONAL ALFALFA, AS WELL AS EACH AMICUS, SUSTAINED AMORTIZABLE DEBT DISCOUNT WHEN THEIR DEBT SECURITIES WERE EXCHANGED FOR DEBT AND/OR STOCK.

In the case of National Alfalfa, and in the situation relating to each of the amicus-taxpayers in this proceeding, debt securities were issued in exchange for old debt and/or stock where the fair market value of the old securities and/or stock was less than the maturity value of the new debt securities issued in exchange therefor.

Section 163 of the 1954 Internal Revenue Code provides:

> (a) General Rule. There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

Income Tax Regulations, Section 1.163-3 provides:

> Sec. 1.163. Deduction for bond discount.
>
> (a) Discount upon issuance. (1) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds.* * *

It is now a well-established principle that debt discount is additional interest paid or accrued for the use of

borrowed capital, or compensation for the use or forebearance of money (*Deputy v. DuPont*, 308 U.S. 488, 498 (1940); *Helvering v. Union Pacific Company*, 293 U.S. 282, 286; *Dodge Bros. v. Commissioner*, 118 F.2d 95, 103 (CA-4, 1941); *Court Holding Company*, 2 TC 531 (1943), 143 F.2d 823 (CA-5, 1944), rev'd on other grounds, 324 U.S. 331 (1945); *Central Station Signals, Inc.*, 10 T.C. 1015 (1948), aff'd. per curiam, 174 F.2d 479 (CA-2, 1949). The liability for the payment of such additional interest is created when the maturity value of the debt securities issued exceeds the proceeds or consideration received upon issuance of such debt obligations. Where debt discount occurs, as in the case of all the present parties, it must be amortized by an accrual basis obligor ratably over the life of the debt to which it is attributable. (*Helvering v. Union Pacific Company*, supra, Income Tax Regs., Section 1.163-3, 1954 Code).

In its brief in *National Alfalfa*, page 7, the Government argued that in order for discount to exist, there must be an outlay, or an obligation to make an outlay, in excess of the amount of borrowed capital. The question is not whether the taxpayers here involved have obtained new capital or retained their capital borrowings at the old level, but whether such corporations have obligated themselves, because of money market conditions or other reasons, to pay additional interest for the use of their borrowed capital. Each of such corporations has obligated itself to pay additional interest over the term of the debt to effectuate the exchange. A taxpayer has the unqualified right under the Federal Income Tax statutes and regulations to deduct from his gross income in a tax year interest actually paid or accrued in such year in a bona fide transaction (*National Alfalfa*, supra).

Because of the divergent views, reasoning and confusion relating to the debt discount problem, expressed

by the lower courts in recent cases, i.e., *National Alfalfa*, supra, *Atchison, Topeka and Santa Fe Railroad v. United States*, 433 F.2d 147 (CA-10, 1971), *Cities Service Company v. United States*, 316 F.Supp. 61 (S.D.N.Y., 1970), *Claussen's, Inc. v. United States*, Civil No. 1350 (S.D.Ga., 7/29/71, reversed and remanded, 469 F.2d 340 (CA-5, 1972), *Erie Lackawanna Railroad Co. v. United States*, 422 F.2d 425 (Ct. Cl.), *Missouri Pacific Railroad Co. v. United States*, 427 F.2d 727 (Ct. Cl.), modified, 433 F.2d 1324, cert. den. 402 U.S. 944, there is an overwhelming need for this Court to allay the confusion and resolve the conflicts between the various circuits. The problem is national in scope and requires authoritative resolution by this Court.

Over the years and particularly within the last four decades, a large number of railroads have had to undergo reorganization in bankruptcy. Indeed, the extent of this phenomenon and the national concern involved finds recognition in the special provisions which have been added to the Bankruptcy Act (11 U.S.C. Section 205) to handle this class of economically distressed business corporations. As a part of these reorganizations, new securities issued in exchange for the older outstanding classes of securities, with discount or additional interest being the inducement to the holders of the old securities to agree to the plan. The issuance of debt at sharp discounts has long been present in railroad reorganizations and the tax impact of denying the deduction to the reorganized road during precarious post-reorganization periods defeats the purpose and hope of the reorganization.

The courts below, in a number of recent cases, have confused debt discount with loss. As will be discussed below, there are no basis problems involved in the present case. What is involved here is the additional cost National Alfalfa and each of the amici in their respective cases had

to incur in addition to the interest specified in the obligation issued by each of the respective parties. The additional cost was interest deductible over the life of the obligation (*National Alfalfa*, supra). The substance of the National Alfalfa transaction, like that of each amicus, was no different than the borrowing of money by issuing bonds at a discount followed by the purchase of the old debt or old preferred stock at their respective fair market values. The courts below agree that in that situation there is discount but they refuse to see it where the new obligations are issued directly for the old, with the first step of issuing the bonds for cash being omitted. In treating the bonds and preferred stock of the issuer as a special class of property calling for special treatment, the courts below have created an arbitrary distinction beyond all legislative sanction.

II.

AMORTIZABLE DEBT DISCOUNT HAS NO RELATIONSHIP WITH "LOSS" UNDER THE PROVISIONS OF THE INTERNAL REVENUE CODE.

At pages 12-13 of its brief, in *National Alfalfa*, petitioner-Government argues that until the decision of the Court of Appeals for the Tenth Circuit, it had been generally assumed that whether discount was characterized as an interest expense or as a loss was of no practical significance because under either terminology, a deduction for bond discount serves to reduce the tax liability of the issuing corporation. Petitioner's argument continues that, however, in order for bond discount to arise, there must be an outlay, or an obligation to make an outlay, in excess of the original capital borrowed. It appears that petitioner is urging this Court to adopt petitioner's untenable and outdated theory that where

debt obligations are issued by a corporation in exchange for its old, outstanding debt or stock, such transaction represents only a recapitalization, controlled only by the reorganization and gain or loss provisions of the Code and that Code Section 163, relating to interest paid or accrued, must be ignored. Petitioner's assessment of the exchange is erroneous.

The question here presented is not whether the exchange in each of the present cases was taxable or non-taxable or what the basis is of the property exchanged under the Section 368 reorganization provisions of the Code, but, instead, whether National Alfalfa and each amicus sustained debt discount upon the issuance of debt obligations to acquire their extant debt or stock. If debt discount or an obligation to pay additional interest was thus incurred, National Alfalfa and each amicus would be entitled to debt discount amortization deductions under Section 163 of the Code, which provides that all interest paid or accrued in a taxable year on indebtedness constitutes a deductible expense (Section 163(a), 1954 Code). The tax basis of the stock or other property acquired by the respondent or amicus upon issuance of their new debt is quite irrelevant to the question of whether amortizable debt discount was incurred. Only the fair market value of the old debt or stock acquired in relation to the new debt's maturity value would be pertinent.

A concrete example of the operation of debt discount up to and including the redemption of a security will help dispel the aura of confusion created by petitioner's erroneous reference to debt discount as "loss" or an "outlay, or an obligation to make an outlay, in excess of the original borrowed capital."

Assume that a taxpayer issued its new 10 year, 5%-$100 bond for an old bond of similar maturity value

having a fair market value of $90. Taxpayer has sustained debt discount of $10, measured by the difference between the $100 maturity value of the new bond and the $90 market value of the old bond at the time of exchange. When the new bond is paid off or redeemed at maturity (10 years from issuance), taxpayer will pay out the principal amount of $100 and will have paid stated interest of 5% per year for 10 years, for which interest expense he will have received a tax deduction. Also taxpayer would have been entitled to and would have taken a tax deduction for the amortizable debt discount (additional interest) at the rate of $1.00 per year. Such accounting does not encompass any gain or loss situation as amortization of such interest expense has no bearing on tax basis (Income Tax Regs., Section 1.1032-1).

The only manner in which gain or loss and tax basis would enter into this hypothetical situation would be in connection with a sale or other disposition of the bond by the bondholder before maturity. If the bondholder had a tax basis of $90 in such bond and sold it for more or less than $90, gain or loss to such bondholder would be based upon the difference between the $90 tax basis and the amount realized upon such sale. That transaction would not affect a taxpayer's liability to pay its obligation for debt discount based upon the maturity value of the bond as well as the 5% stated interest. If the debtor redeems its $100 maturity value bond at the end of the fifth year for $90, the $5.00 of amortized discount will constitute gross income to the debtor under Section 61(a)(12) of the Code. If the debtor had received property having a fair market value of $90 for its $100 bond its basis for the property would be $90 and would remain completely unaffected by the debtor's amortization of the $10 of discount on the debt's retirement prior to maturity at a $5 gain by the debtor. The tax

consequences[2] of the issuance of debt at a discount and the ultimate retirement are quite separate and distinct from the tax consequence resulting from the acquisition, retention and disposition by the debtor of the consideration received upon such debt's issuance.

Because of petitioner's several confusing references to and the characterization of the debt discount involved in the subject cases, it is imperative to bear in mind that gain, loss or tax basis transactions when dealing with property dispositions are covered by the tax basis provisions of the Code (Section 1031, et seq.). Discount on the issuance of debt is treated separately under the bond discount provisions (Section 163).

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[2] The Commissioner of Internal Revenue and certain lower courts have taken the position that respondent and each amicus are not entitled to amortize and deduct the debt discount (for example $1,000,000) at which their debt securities were issued. IRS and those courts have also taken the position that there should be included in taxable income the difference between the par or face value and purchase price whenever the taxpayers reacquire any of their debt obligations. The absurdity of such determinations is made apparent if we assume that a taxpayer, on one day, issued its debentures for preferred stock with a value of $1,000,000 less than the principal amount of the debentures and then, on the next day, reacquired the debentures for exactly the same price at which the preferred stock was selling on the previous day. Applying the erroneous determinations of the IRS, taxpayer would be in receipt of taxable income in the amount of $1,000,000 because it acquired its preferred stock by issuance of debentures retired one day after issuance rather than by purchasing its stock for cash. This totally illogical result is not possible because taxpayer's debentures were, in fact and in law, issued at a discount of $1,000,000 and the gain or loss upon reacquisition of such debentures must be determined by reference to their issue price (the fair market value of the preferred stock received) with the result that no "make believe" or phantom income is generated by the transaction.

III.

WHERE NEW DEBT IS ISSUED IN EXCHANGE FOR OLD DEBT OR STOCK, FAIR MARKET VALUE OF THE OLD DEBT OR STOCK RECEIVED IS THE PROPER BASIS FOR MEASURING DEBT DISCOUNT.

When new debt is issued by a corporation having a maturity value in excess of the value of the old securities or stock received in exchange therefor, the question arises as to what is the measurement of the debt discount incurred. What is the proper method to be used for determining the amount of debt discount? On this point, except for a few sound and well-reasoned discussions,[3] the law pronounced by the lower courts borders on the chaotic.

In *National Alfalfa*, as in each of the amicus cases, the measure of debt discount incurred and claimed was established by comparing the maturity value of the new debt issued with the fair market value, based upon New York Stock Exchange quotations, of the old debt or stock received in exchange. The difference between such maturity value and the fair market value represented debt discount as claimed by the taxpayer.

Fundamentally "fair market value" is defined as the price at which property would change hands between a willing buyer and willing seller, neither being under any compulsion to buy or sell. In each case in question, taxpayer's old debt securities and stock had a public market and were regularly traded on the Exchange.

[3](a) *National Alfalfa Dehydrating & Milling Co. v. Commissioner*, 472 F.2d 796 (CA-10, 1973).

(b) *American Smelting & Refining Co. v. United States*, 130 F.2d 883 (CA-3).

(c) *Nassau Lens Co. v. Commissioner*, 308 F.2d 39 (CA-2).

Exchange prices and quotations reflect changes in corporate structures, operations and transactions and, therefore, generally represent a reliable price or fair market value for such corporate securities. Where debt securities and stock are listed and freely marketed in substantial amounts on a recognized exchange, the mean price between two trading prices on a given date is regarded as the fair market value for that date (*Leon R. Meyer et al. v. Commissioner*, 46 T.C. 65 (CA-8), 383 F.2d 883, aff'g., vac'g. and rem'g. T.C. on other grounds; *John J. Batterman*, 1 T.C.M. 667, aff'd. 142 F.2d 448).

On numerous occasions the Commissioner of Internal Revenue has taken the position, which has been upheld by the Courts, that the best and preferred basis for valuing stocks and bonds is reference to quoted market prices. That position has been maintained and sustained in every field of tax determination where value of stocks and securities was pertinent. For example, the United States District Court, S.D., New York, in *Southern Pacific Company v. United States*, 110 F.Supp. 637 (1953), involving the determination of liability for documentary stamp tax, adopting and quoting the Commissioner's position that use of the quoted market value was the proper basis for valuing stock, stated:

> In the case of stocks listed upon an exchange, the mean between the highest and lowest quoted selling price is considered as its market value.

That basis for determination of value of stocks and bonds is the same basis prescribed for Estate Tax and Gift Tax valuation purposes under the provisions of Section 2031 of the 1954 Code, Treasury Regs., Section 20.2031-2(b) and Section 25.2512-2(b).

In the present cases, respondent and each amicus established the market price of its securities and stock for

each exchange transaction and petitioner-Government admitted that the prices used by the former parties represented the New York Stock Exchange value. In *American Smelting & Refining Company*, supra, the Appellate Court opined that the taxpayer had carried its burden of proof and had sufficiently proved the value of what was received in exchange for its new debt securities for measuring debt discount by reference to the open market of the New York Stock Exchange.

The Appellate Court in *National Alfalfa*, supra, stated:

> It is firmly established by the adjudicated cases that where a corporation issues its bonds, including debenture bonds, which unconditionally oblige the corporation to pay the principal amount stated therein; together with interest thereon, at the times therein provided, and receives therefor the amount of the principal, less a discount, the amount of such discount is deductible as interest paid and should be amortized over the life of the bonds or debenture bonds.

As part and parcel of the Appellate Court's holding in *National Alfalfa*, the Court also adopted the measurement of the debt discount claimed on the basis of the difference between the maturity value of the debentures and the market value of the stock received in exchange for such debt securities.

IV.

RESPONDENT'S CONTENTIONS AND THEORIES WITH RESPECT TO DEBT DISCOUNT DO NOT MEET THE TESTS OF PREVAILING LEGAL PRINCIPLES.

In *National Alfalfa*, the Appellate Court stated that the two Court of Claims' decisions,[4] relied upon by petitioner, were followed by the Tax Court in its decision in the instant case, but that there is other respectable authority to the contrary. Moreover, the Court continued, the two Court of Claims' decisions and the decision (Tax Court) in the instant case, as has heretofore been shown, are based on an erroneous premise, namely, that the question is not whether there was a debenture discount which served the purpose of stated interest, but whether there was a loss suffered. As indicated by the Appellate Court, the Court of Claims' misconception of the law applicable to debt discount is fatal to the persuasiveness of its decisions in the debt discount area.

In its arguments, at pages 8, 9 and 14 of its brief, petitioner contends no discount could arise from the issuance by National Alfalfa of its $50 debentures in exchange for its $50 preferred stock because of the arithmetical equivalence of the transaction. However, the long-established method of determining a debt discount transaction, as correctly reasoned and upheld by the Tenth Circuit Court of Appeals, clearly showed that by the most universal standard of security valuation, i.e., New York Stock Exchange value, arithmetical equivalence did not exist because the preferred stock at the

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[4] Even the Government, while subscribing to the results of such cases, finds fault with the Court's reasoning and labels them as misconceptions of the law.

time of exchange was valued at $33 per share, leaving debt discount of $17.

The method of measuring debt discount as adopted by the Appellate Court in *National Alfalfa*, supra, and as previously upheld in *American Smelting*, supra, i.e., debt discount is the difference between the maturity value of the new debt and the fair market value of the old debt or stock exchanged therefor, has the genuine quality of simplicity of application and lends symmetry to the entire transaction for tax and accounting purposes. Petitioner also contends that the exchange of securities in *National Alfalfa* did not have any major investment significance. Even the most cursory examination of the exchange, points up the fallacy of the proposition. That exchange like all the exchanges here involved, completely changed the relationship of the corporation and its lenders from that of an equity status to a creditor relatoinship, with the corporation now obligated to pay—not only the stated interest on the debt obligations, but also additional interest over the term of the new obligations. The significance of the investment change is quite apparent.

The analogy which petitioner draws (brief, p. 13), between the present case and *Old Mission Portland Cement Co. v. Helvering*, 293 U.S. 289, is inapposite. *Old Mission* is readily distinguishable from the present debt discount cases on a factual basis. In *Old Mission*, the Court concluded that because a subsidiary's bonds were held by another subsidiary, both of which joined in a consolidated return with their parent, the obligation to pay debt discount interest was eliminated as an intercompany transaction under the consolidated return statutes and regulations. In *National Alfalfa* and the case of each amicus the debt principal as well as the obligation to pay additional interest to third parties remained viable. In

Old Mission there was an obvious merger of the obligation to pay the principal and interest and the right to receive payment thereof into a single entity. The only fact the two types of cases had in common was the mere issuance of bonds.

Petitioner contends, commencing at page 19 of its brief (p. 19-26), that the exchange by National Alfalfa of its debt securities for its outstanding preferred stock was not a transaction analogous to the issuance of bonds for property because there was no acquisition of "property". Stock is property, but even if only minimal credence is allowed to petitioner's proposition, there is no real distinction in the treatment of discount arising upon the issuance of bonds for cash and discount arising upon the issuance of bonds for property, including stock of the issuer or others. Petitioner's proposition is certainly misdirected and wide of the mark because the Second, Third and Tenth Circuit Courts of Appeals have consistently held that, for purposes of Code Section 163 (relating to discount deductible as interest), it is immaterial whether bonds are issued for cash, for stock or for other property. According to the Tenth Circuit Court of Appeals, in *Atchison, Topeka and Santa Fe Railroad Co. v. United States*, 433 F.2d 147 (CA-10, 1971):

> . . . the regulations do not distinguish between bonds issued for cash and bonds issued for property. The regulation recognizes *sub silentio* the economic possibility that discount—that is, deferred interest—may be present when bonds are issued for property as well as for cash. Such discount is likely to arise when the stated rate of interest on the obligation is less than the rate demanded by the market.

The Second Circuit, in *Nassau Lens Company v. Commissioner*, 308 F.2d 39 (CA-2, 1972, rev'g. and rem'g., 35 T.C. 268 (1960), speaking through the then

Circuit Judge, Thurgood Marshall, rejected the proposition that the acquirer of property is not entitled to amortize debt discount arising with respect to obligations issued to obtain such property. That Court said:

> It may well be true that to a 'borrowing buyer' interest or discount payments seem part of the cost of the property. In reality, however, they are the cost of using the money which is needed to purchase the property, a cost not incurred by the buyer with ready cash. . . . The contention asserted (by the Commissioner) is merely that when a seller also becomes a financing medium by taking bonds issued at a discount instead of cash in exchange for property, the tax laws will not recognize a charge for the use of money. We find no support for such assertion and reject it.

Even the Court of Claims, has held in *Missouri Pacific Railroad Company v. United States*, supra, that:

> . . . bond discount can arise where there is a difference between what is given up and what is received, and this can occur in connection with a corporate reorganization. The fact that there is a difference in value between bonds being issued and the securities being given up is enough to invoke the debt discount provisions. The ultimate result of the difference is that the corporation is obligating itself to pay a debt which is greater in value than that which it is receiving . . . consequently, any difference between (the original cost of the securities) and the maturity value of the bonds should be treated as a discount and amortized over the life of the bonds.

In addition, Congress, in its recent amendment of Section 1232(b)(2) of the 1954 Code, by enactment of Section 413 of the Tax Reform Act of 1969, did not distinguish or in any way separate stock from other

property in its treatment of debt discount. The Congress further provided that debt discount can arise where debt is issued for stock or other property and that such discount is measured by the difference between the maturity value of the debt and the fair market value of the property received in exchange therefor. The main congressional concern was the practical one of how is fair market value to be established. Hence, the property acquired for new debt must, in order for debt discount to arise under the new law, be traded on an organized exchange. Petitioner's contentions are wholly inconsistent with the statutory treatment of such discount.

Commencing at page 28 of its brief, petitioner contends that no discount could arise upon respondent's exchange of its $50 debentures for its outstanding preferred stock for which it had previously received $50. In support of that proposition, petitioner cites and discusses several recent decisions of the Court of Claims,[5] which the Tenth Circuit solidly rejected as being decided upon an erroneous premise.

In attempting to equate what was given with what was received from the standpoint of gain or loss, rather than focusing upon the interest expense aspect of the transaction, the Court of Claims decisions barred the finding of discount in any exchange of bonds for securities or other property by adopting the standard that what was received in exchange for bonds was equal to what was parted with in the bonds. By using the "value to the taxpayer" and the "equivalence" theory the Court of

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[5](a) *Erie Lackawanna Railroad Co. v. U.S.*, 422 F.2d 425.
(b) *Missouri Pacific Railroad Co. v. U.S.*, 427 F.2d 727, modified, 433 F.2d 1324, cert. den., 402 U.S. 944.
(c) *St. Louis San Francisco Ry. Co. v. U.S.*, 444 F.2d 1102, cert. den., 404 U.S. 1017.

Claims has erroneously introduced into an already confused area of law, a subjective standard which is incapable of measure by any known methods, thereby further compounding the problems of administering the tax law. It should be noted that if such a standard, with its dismissal of market value, were employed in the area of bargain sale, there could be no income in such situations, since it would have to be assumed that the purchaser received in value what he parted with in price regardless of the fact that similar property was being sold for several times that price in the open market.

National Alfalfa and each of the amici contend that the proper standard for measuring discount is the fair market value of what was received in exchange for the securities issued. The general rule for determining what is received in an exchange where property is concerned is its fair market value. This rule applies to bonds as well as other forms of property (*Gerard Trust Company v. United States*, 166 F.2d 773 (CA-3, 1948)). There is no reason why, in determining what amount of discount, if any, was involved, the fair market value of the old securities should not be used in computing such discount.

CONCLUSION

Based upon the foregoing propositions, the Tenth Circuit's decision in *National Alfalfa* should be affirmed and declared to be law with respect to the determination and measurement of debt discount.

Respectfully submitted,

ROBERT T. MOLLOY
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APPENDIX A

Office of the Solicitor General
Washington, D.C. 20530

November 21, 1973

Robert E. Simpson, Esquire
Molloy, Simpson & Dunham, P.C.
Rosslyn Building, North
1911 North Fort Myer Drive
Arlington, Virginia 22209

Re: Commissioner v. National Alfalfa Dehydrating and Milling Co., Supreme Court of the United States
Docket No. 73-9

Dear Mr. Simpson:

As requested in your letter of November 15, 1973, I consent to the filing by the St. Louis-San Francisco Railway Co., Missouri Pacific Railroad Co. and the Gulf, Mobile & Ohio Railroad Co., of a brief amicus curiae in support of the respondent in the above-captioned case.

Sincerely,

Robert H. Bork

Robert H. Bork
Solicitor General

APPENDIX B

LINDE THOMSON VAN DYKE FAIRCHILD & LANGWORTHY

LAW OFFICES
900 WALNUT STREET
KANSAS CITY, MISSOURI 64106
TELEPHONE 474-6470
AREA CODE 816

October 19, 1973

Mr. Robert E. Simpson
Molloy Legal Services, Inc.
Rosslyn Building North
1911 North Fort Myer Drive
Arlington, Virginia 22209

Re: National Alfalfa Dehydrating and Milling Company v. Commissioner, Supreme Court, Docket No. 73-9
Participation as Amicus Curiae of St. Louis - San Francisco Railway Company

Dear Mr. Simpson:

We are in receipt of your letter dated October 11, 1973 wherein you request our consent to your intervention as an amicus curiae.

We would welcome your support in this case and would suggest that you take whatever actions you feel necessary in order to accomplish your entrance as an amicus curiae. We anticipate similar requests from Norton Simon, Inc. and Cities Service Company and similarly intend to consent to their presence in the case.

Norton Simon, Inc. is represented by Mr. Walter J. Rockler of Arnold & Porter, Washington, D.C. while Cities Service Company is represented by Mr. Thomas E. Tyre of Casey, Craig & Constance, 345 Park Avenue, New York, New York.

As you know, the Supreme Court Rules provide that oral argument may be granted to an amicus curiae only if the party being supported by the amicus gives up a portion or all of its time. On this point, we want you to know that we intend to use the full time allotted to us for oral argument.

If you have any additional questions or suggestions, please do not hesitate to contact us. You may also wish to contact Messrs.

Rockler and Tyre.

Very truly yours,

LINDE THOMSON VAN DYKE FAIRCHILD & LANGWORTHY

BY: Charles W. Hoes, Jr.

CWhH:lw
cc: Mr. Walter J. Rockler
Arnold & Porter
1229 19th Street, N.W.
Washington, D.C. 20036

Mr. Thomas E. Tyre
Casey, Craig & Constance
345 Park Avenue
New York, New York 10022

APPENDIX C

* * *

[¶ 9194] National Alfalfa Dehydrating and Milling Company, Petitioner-Appellant v. Commissioner of Internal Revenue, Respondent-Appellee.

U. S. Court of Appeals, 10th Circuit, No. 72-1125, 1/26/73. Reversing and remanding Tax Court, 57 TC 46, CCH Dec. 31,030.

[Code Secs. 61(a) and 163(a)]

Amortization: Bond issue discount: Exchange of debentures for outstanding preferred stock.—Amortizable bond discount resulted upon the issuance by the corporate taxpayer of debentures, each with a $50 maturity value, in exchange for its outstanding preferred stock with a fair market value per share of $33, made on a one-for-one basis. The court rejected the argument that no discount occurred since the $50 maturity value of the debentures issued was equal to the amount originally received upon issuance of each share of $50 par value preferred stock, and that no loss resulted. One dissent. Back references: ¶ 674.098 and 1423.20.

Charles White Hess, Ronald B. Stang, Linde, Thomson, Van Dyke, Fairchild & Langworthy, Floor Three, Columbia Union Bank Bldg., Kansas City, Mo., for petitioner-appellant. Ernest J. Brown, Scott P. Crampton, Assistant Attorney General, Meyer Rothwacks, Department of Justice, Washington, D. C. 20530, for respondent-appellee. Stuart S. Opotowsky, Alan D. Berlin, Walter J. Rockler, Julius M. Greisman, Richard L. Hubbard, Arnold & Porter, for N. Simon, amicus curiae.

Before PHILLIPS, HILL and HOLLOWAY, Circuit Judges.

PHILLIPS, Circuit Judge: National Alfalfa Dehydrating and Milling Company, hereinafter called National Alfalfa, was incorporated under the laws of Delaware on May 4, 1946. It was authorized to engage and did engage in the business of dehydrating and milling alfalfa.

The question presented in this case is whether National Alfalfa incurred amortizable and deductible bond issue discount, deductible as interest paid, when it issued its 18-year, five per cent, sinking fund debenture bonds, hereinafter referred to as debentures, each for the principal sum of $50, to be preferred stockholders in exchange for their preferred stock, on the basis of one $50 debenture for each share of preferred stock of the par value of $50, when at the date of the exchange the fair market value of the preferred stock was only $33 per share.

[Facts]

Prior to July 23, 1957, National Alfalfa had issued and outstanding 47,059 shares of $50 par value, five per cent, cumulative preferred stock in an aggregate par value amount of $2,352,950, and as of that date there was a dividend arrearage on each of such shares of $10. Such preferred shares were redeemable at the discretion of National Alfalfa, in whole or in part, at prices ranging from $53 per share for shares redeemed prior to December 1, 1949, to $51 per share for shares redeemed after December 1, 1955, plus accumulated and unpaid dividends down to the date of redemption.

When redeemed, such preferred shares could not be reissued by National Alfalfa, but had to be cancelled and retired by it.

National Alfalfa was required to set aside annually after September 1, 1948, 20 per cent of its consolidated net earnings,

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after a payment of accrued dividends on its outstanding preferred stock, for the purpose of redeeming preferred shares, as long as any were outstanding. However, such preferred shares could not be redeemed with funds in the sinking fund, nor purchased or acquired for value by National Alfalfa at any time when there were dividend arrearages thereon, unless consented to by the holders of 50 per cent of the preferred shares, or unless National Alfalfa notified all of its preferred shareholders of its desire to purchase such shares and invited them to tender offers.

On April 8, 1957, the Board of Directors of National Alfalfa adopted several resolutions which are set out in Note 1 hereto.[1]

The Board of Directors, by such resolutions, approved certain corporate actions, which, if approved by a two-thirds vote of each class of its shareholders and carried out, would constitute a reorganization of National Alfalfa within the meaning of 26 U. S. C. A. § 368(a)(1)(E). Such actions were:

1. The entering into of a trust indenture with Fidelity-Philadelphia Trust Company

[1] The text of the resolutions is as follows:

"RESOLVED, that the officers of the Company, be and they are hereby authorized to effectuate a reorganization of the Company by way of recapitalization, and

"RESOLVED, that the President or Vice-President and the Secretary or Assistant Secretary of the Company be and they are hereby authorized to enter into a trust indenture with Fidelity-Philadelphia Trust Company of Philadelphia, Pennsylvania, dated, as of July 1, 1957, pursuant to the terms of which there shall be issued $2,352,950.00 principal amount 5% Debentures, due July 1, 1975, which said bonds shall be issued in exchange for shares of the 5% Cumulative Preferred Stock on the basis of $50.00 principal amount of such debentures for each share of preferred stock and that this resolution, when ratified by the shareholders shall constitute authority for said issue, and

"RESOLVED, that the Company be authorized to issue warrants for the purchase of the common stock of the Company to each preferred shareholder participating in the exchange of his preferred stock for Debentures of the Company in the reorganization effective August 1, 1957, on the basis of one warrant for each share of Preferred Stock surrendered, said warrants to evidence the right to purchase one-half (½) share of common stock and said warrants to be exercisable to purchase only full shares of common stock of the Company at a price of $10.00 per share at any time from the date of issue until July 1, 1969 or so long as any debenture bonds remain outstanding, after which date warrants will become void, and

"RESOLVED, that the Company increase the par value of its shares from $1.00 to $3.00 and that the amount of $1,560,000.00 be transferred from Paid-In-Capital to the Capital Account in order to effectuate this resolution and reflect the increase in par value of the Common Stock, and

"RESOLVED, that the Articles of Incorporation of the Company be amended by changing Article FOURTH to read as follows:

"'The total number of shares of stock which the Corporation will have authority to issue is 1,000,000 shares of Common Stock of the par value of $3.00 per share.

The minimum amount of capital with which the Corporation will commence business will be $1,000.00.'

"1. Each share of Common stock shall be entitled to one vote per share in any matter requiring a vote of shareholders and each share shall be entitled, upon any liquidation, dissolution, or winding up of the affairs of the Corporation, whether voluntary or involuntary, to participant pro-rata in the assets available for distribution.

"2. No holder of shares of stock of the Corporation shall be entitled, as such, to subscribe to or purchase any additional shares of stock, whether now or hereafter authorized, or obligations convertible into any class or classes of stock, or shares of stock of any class convertible into any class or classes, or obligations, shares of stock or other securities carrying warrants or rights to subscribe to shares of stock of the Corporation of any class or classes, in any case whether now or hereafter authorized, but any and all shares of stocks, bonds, debentures or other securities or obligations, whether or not convertible into stock or carrying warrants or rights entitling the holders thereof to subscribe to stock may be issued, sold or disposed of from time to time by the Board of Directors to such persons, firms or corporations and for such consideration, so far as may be permitted by law, as it shall from time to time in its absolute discretion determine, without offering the same to the holders of shares of stock of the Corporation or any class then outstanding.

"3. The Company shall be entitled to issue warrants for the purchase of common stock on such terms as the Board of Directors may determine but such warrants when issued shall be binding on future actions of the Board of Directors and the terms thereof shall not be altered, amended or repealed without the consent of such warrant holders. AND

"RESOLVED, that this resolution and the reorganization and recapitulation contemplated hereby be submitted to a vote of the shareholders, and if adopted by the requisite number of shareholders, all rights and privileges of the 5% Cumulative Preferred Shares heretofore expressed or inherent in the ownership of said Preferred Stock shall cease and determine as of August 1, 1957, except such right to surrender the said shares of stock on the terms herein contained except as otherwise provided by law; and

"RESOLVED, that the officers of the Company be hereby authorized to submit the Plan of Reorganization to the Commissioner of Internal Revenue in an attempt to have the said Plan qualified as a tax free reorganization under the Internal Revenue Code of 1954; and

"RESOLVED, that the officers of the Company be hereby authorized to incur any and all necessary expenses to effectuate the Plan of Reorganization approved and adopted by this meeting of the Board of Directors."

of Philadelphia, Pennsylvania, as trustee, dated July 1, 1957, pursuant to the terms of which there would be issued $2,352,950 principal amount five per cent debentures, due July 1, 1975, and such debentures would be exchanged for all the shares of the outstanding cumulative preferred stock of National Alfalfa on the basis of one debenture for the principal amount of $50 for each share of such preferred stock of the par value of $50;

2. The issuance to each preferred stockholder participating in the exchange of his preferred stock for debentures of warrants effective August 1, 1957, for the purchase of common stock of National Alfalfa, on the basis of one warrant for each share of preferred stock exchanged, such warrants evidencing the right to purchase one-half share of common stock, but exercisable only for the purchase of full shares of such common stock at $10 per share at any time from the date of issue of such warrants to July 1, 1969; such warrants to be issued to and accepted by preferred stockholders participating in the exchange in lieu of the arrearage of cumulative dividends on their preferred stock;

3. (a) The amendment of the articles of incorporation of National Alfalfa, so as to provide for the issuance only of common stock;

(b) Increasing the number of shares of common stock from 763,000 to 1,000,000, and increasing the par value of the stock from $1 to $3.

The principal purpose of the reorganization was to enable National Alfalfa to extend easterly the territory in which it did business and effect a 50 per cent increase in its borrowing credit, which would be required by it for carrying the increased inventory which would result from such expansion. Such increase in the borrowing credit of National Alfalfa would be accomplished by issuing the five per cent debentures to the preferred stockholders in exchange for their preferred stock and the issuance to the preferred stockholders of the warrants to purchase common stock in discharge of the cumulative dividend arrearage.

The resolutions adopted by the Board of Directors of National Alfalfa were duly approved by the requisite number of votes of each class of stockholders at the regular annual meeting of National Alfalfa, held on July 23, 1957, and thereafter all of such resolutions were carried out.

National Alfalfa delivered to each of its preferred stockholders one $50, five per cent, debenture for each share of preferred stock held by such stockholders, and each of such stockholders delivered to National Alfalfa all of the shares of preferred stock held by him, and National Alfalfa retired such preferred stock.

In replying to a request for a ruling by Fidelity-Philadelphia Trust Company, the Treasury Department said in a letter to the Trust Company that no gain or loss would be recognized on the exchange of the $1 par value common stock for $3 par value common stock under the provisions of § 368 (a)(1)(E) of the Internal Revenue Code of 1954, but gain or loss would be recognized to the preferred stockholders on the exchange of their preferred stock for debenture bonds.

National Alfalfa also delivered to each of such preferred stockholders and each of them accepted warrants to purchase common stock of National Alfalfa, as set forth above, in satisfaction of the dividend arrearage on his preferred stock.

The indenture required that National Alfalfa should create a sinking fund for the retirement of the debentures by the following provision:

> "The Company (National Alfalfa) covenants and agrees that on or before the expiration of 90 days after the end of each fiscal year of the Company commencing with the fiscal year ending April 30, 1959, it will pay to the Trustee as and for a contingent sinking fund for the redemption of Debentures at the sinking fund redemption price of 100% of the principal amount of the Debentures so to be redeemed, together with accrued interest to the redemption date, a sum in lawful money of the United States of America sufficient to redeem $196,080 principal amount of said Debentures, provided that in any year when the Consolidated Net Income is insufficient to redeem $196,080 principal amount of said Debentures the amount required to be paid over to the Trustee shall be 100% of such Consolidated Net Income and the difference between that sum and $196,080 shall accumulate to be paid from the Consolidated Net Income of subsequent years and provided further that the Company must commence the accumulation of income for sinking fund purposes by setting aside 100% of Consolidated Net Income up to $196,080 in each year commencing with the year beginning May 1, 1957."

National Alfalfa has never been in default in the performance of anything required

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to be done by it by the terms of the debentures and the indenture.

On April 30, 1967, only 11,626 of the original debentures issued by National Alfalfa remained outstanding, and it had redeemed or otherwise repurchased and retired the other 35,433 debentures issued by it.

As shown by over-the-counter bids to purchase and offers to sell, the fair market value of each share of the preferred stock on July 23, 1957, was $33.

The debentures expressed unconditional and legally enforceable obligations on the part of National Alfalfa to pay the face amount thereof, with accrued interest, at the times and in the manner provided therein.

The indenture provided that:

> "This Indenture and the Debentures issued hereunder shall be subordinate only to current bank borrowings for inventory purposes which obligations mature by their original terms in less than twelve months and obligations of the Company (National Alfalfa) to suppliers of materials, services and labor incurred in the normal course of the Company's business and reasonably required in its operations, which obligations are due and payable when billed, and to any existing liens, encumbrances, mortgages, conditional sales agreements, or pledges, or any replacement, renewal, or extension thereof * * *"

and, unless consented to by the holders of at least 66⅔ per cent of the debentures outstanding when done, it should not be subordinated to any funded debt created, issued, assumed, or guaranteed by National Alfalfa or any subsidiary thereof, with certain enumerated exceptions.

The indenture contained many other provisions for the protection of the priority of the debentures and the rights of the debenture holders, but it would unduly lengthen this opinion to set them out in detail.

In its income tax returns for its fiscal years ending April 30, 1958, through April 30, 1967, National Alfalfa claimed deductions for interest paid by reason of the debenture discount alleged to have resulted from the difference between the fair market value of $33 of the preferred stock on July 23, 1957, and the face amount of the debentures then issued by it to the holders of its preferred stock. These deductions were computed on the basis of straight line amortization of the interest discount and the amortized amounts with respect to debentures retired in those years. The deductions in earlier years were included in losses carried over to the fiscal year ending April 30, 1967.

The Commissioner of Internal Revenue disallowed National Alfalfa's claimed deduction of $109,804 for interest paid, resulting from debenture discount for its fiscal year ending April 30, 1967, and also disallowed $321,657 of claimed deductions for interest paid, resulting from like discounts for the fiscal years ending April 30, 1958, through April 30, 1966, and determined deficiencies accordingly. Upon National Alfalfa's petition to the Tax Court to review the action of the Commissioner, the Tax Court affirmed the deficiencies asserted by the Commissioner. From the decision of the Tax Court, National Alfalfa has appealed to this court.

[*Discount Is Interest Not Loss*]

The decision of the Tax Court was based on the asserted proposition that where a corporation has issued its five per cent cumulative preferred stock at a stated par value (here, $50 per share) and thereafter issues its $50 debentures obligating it to pay the principal thereof at the times stated therein, and in the indenture under which the debentures were issued, together with interest at a stated percentage (here, five per cent) at the times stated in the debentures (here, semiannually), and exchanges such debentures for its preferred stock on the basis of one debenture for each share of preferred stock, although the market value of the preferred stock is less than its par value at the time of the exchange (here, $33 per share, or $17 less), thus giving the preferred shareholders a discount from the stated principal amount of the debentures (here, a discount of $17 per share), a corporation issuing the debentures (here, National Alfalfa) is not entitled to a discount reduction as for interest paid, amortized over the life of the debentures, for the reason it received for each preferred share at the time it was issued the identical amount of the stated principal payable under each debenture and therefore suffered no loss. And it so held; notwithstanding while the Treasury Regulations originally treated bond discount as a loss, since prior to 1957 they have treated it as interest paid,[1] which is supported by re-

[1] *See American Smelting & Refining Co. v. United States*, 3 Cir., [42-2 USTC ¶ 9670] 130 F. 2d 883, 885 (1942); Treas. Reg. 33, Rev. Art. 150; Treas. Reg. 45, Art. 554(3)(ii); Treas. Reg. 62, Art. 545(3)(a); Treas. Reg. 65, Art. 545(3)(a). The Treasury Regulation in effect during the taxable year here involved is § 1.61-12(c)(3), T. D. 6272, 1957-2 Cum. Bull. 18, 32.

spectable authority, as we shall hereafter show.

The applicable Regulation in effect during the taxable year here involved is Treas. Reg. § 1.61-12(c)(3), T. D. 6272, 1957-2 Cum. Bull. 18, 32, which in part here pertinent reads:

"If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds."

Section 1.61-12(c)(3) was amended in 1968 by T. D. 6984, 1969-1 Cum. Bull. 38, and the pertinent language of the former Regulation was carried over to current Treas. Reg. § 1.163-3(a)(1).

A taxpayer has the unqualified right under the Federal Income Tax statutes to deduct from his gross income in a tax year interest actually paid in such year in a bona fide transaction.

As above stated, the Treasury Department, at all times here pertinent, has held that bond or debenture discount is deductible, not as a loss, but as interest paid, amortized over the life of the bond or debenture.

And as we shall show, infra, with the exception of the Court of Claims, the courts that have passed on the question have held that bond or debenture discount arises when the issuer of bonds or debentures exchanges them for preferred stock or securities theretofore issue by it, of less value than such bonds or debentures, and that such difference in value is deductible as interest prorated over the life of the bonds or debentures.

Assume that National Alfalfa sold 200 of its $50 debentures to John Doe at a discount of $17 per debenture and received $6,600 for such debentures; and in the same tax year that it sold such debentures, it purchased from one of its preferred stockholders 200 shares of its $50 par value preferred stock at the market price of $33 per share. Could there be any doubt that National Alfalfa could deduct from its gross income the $17 discount on each of such debentures so sold as interest paid, amortized over the life of the debentures? We think the answer is obviously "No." Yet the $17 discount, plus $33, is exactly the same amount National Alfalfa received for such preferred shares when it sold them.

Assume the same facts stated in the above example, except National Alfalfa sold such 200 debentures at a discount of $17 per debenture to one of its preferred stockholders; and from the same stockholder in the same tax year purchased 200 shares of its preferred stock for $33 per share. Would there be any doubt of the right of National Alfalfa to likewise deduct from its gross income such $17 discount as interest paid, amortized over the life of the debentures? Again, we think the answer is obviously "No," yet as in the first example the $17 discount, plus $33 per share, is the same amount National Alfalfa received for each share of such preferred stock when it sold it.

In substance, there is no difference between the facts in the instant case and the facts in the second example stated above.

Hence, we hold that the decisions of the Commissioner and the Tax Court in the instant case are based on a nonapplicable premise, viz, that National Alfalfa suffered no loss.

At this point, we think it would be helpful if we show what the result would be if National Alfalfa were permitted to deduct as interest amortized or prorated over the life of the debentures, which was 18 years, the difference between $50, the principal amount of each debenture, and $33, the market value of each certificate of preferred stock, or $17. That amount, prorated over the life of the debentures, would be 95 cents per year on each debenture, and would equal interest thereon at the rate of .019 per year. While the discount, in effect, would be paid in advance, the total deduction could not be taken in the tax year in which the exchange took place. It would have to be amortized over the life of the debentures. The picture looks quite different when the result is thus broken down.

[*Case Precedents*]

The Tax Court relied principally on the decisions of the Court of Claims in *Erie Lackawanna Railroad Company v. United States* [70-1 USTC ¶ 9245], 422 F. 2d 425 (1970), and *Missouri Pacific Railroad Company v. United States* [70-1 USTC ¶ 9457], 427 F. 2d 727 (1970).

In the former case, the Railroad Company, after being authorized so to do by the Interstate Commerce Commission, exchanged its five per cent debentures, due January 1, 2020, for shares of Series "A" five per cent preferred stock. The basis of the exchange was one income debenture in the principal sum of $100 for one share of preferred stock having a par value of $100. The market value of the preferred stock at the time of the exchange of the debentures for stock was $22,558,224.46, which was $5,217,975.54 less than the $27,776,200 maturity value of

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the debentures. The Railroad Company claimed such difference rrpresented bond discount and was deductible as interest paid, amortized over the life of the debentures. The Court of Claims held that the Railroad Company was not entitled to deduct such discount, since the amount received by it for its preferred stock when issued was the same as the principal amount of the debentures, and therefore it suffered no loss in the exchange. In the opinion, the court said:

> "The position which this court does take in regard to the issue at hand is that since plaintiff was exchanging $100 debentures for preferred stock for which it had already received $100 in value, then plaintiff lost nothing as a result of the transaction. Since there was no actual difference between the face value of the debentures and the amount received in return for them ($100 preferred stock), there was no discount which could be amortized over the life of the bonds. The fact that the preferred stock had a market value less than $100 at the time of the exchange is of no consequence in this type of transaction where the plaintiff is purchasing its own stock. What is important in this case is the value received for the stock at the time of its issuance. Since plaintiff issued its stock for $100 per share and carried the stock on its books at this amount, this is the figure which should be used to determine whether a discount has arisen. * * *"

In the latter of the two cases, Missouri Pacific and its subsidiaries reorganized in a proceeding under 11 U. S. C. § 205, pursuant to a plan approved by the Interstate Commerce Commission and the United States District Court having jurisdiction of the reorganization proceedings. Under the plan, Missouri Pacific issued: (1) Collateral trust notes; (2) first mortgage 4½ per cent bonds (series B and C); (3) general mortgage income 4¾ per cent bonds (series A and B); (4) 5 per cent 90-year debentures; and (5) stock in exchange for its own outstanding debt securities and stock of its subsidiaries; and the subsidiaries were merged into the parent corporation.

The terms of the exchange varied. In some cases, bondholders received new debt securities equal in amount to the sales value of the sum total of their bonds, plus interest accrued and unpaid by Missouri Pacific and its subsidiaries during the process of the reorganization. The accrued interest was deducted by Missouri Pacific from its gross income for federal income taxes in the year it became due. It also took deductions for amortized bond discount, predicated on the fact that the aggregate value of the new bonds issued pursuant to the plan was greater than the value of the securities received in exchange, as shown by New York Stock Exchange price quotations. Missouri Pacific claimed that the aggregate maturity value of the bonds was $529,117,141, while the fair market value of the old securities received in the exchange was $452,151,252, or a difference of $76,965,889, and that such difference in value represented debt discount and was deductible as interest amortized over the life of the new bonds. The court held that Missouri Pacific was not entitled to deduct such discount, because the par value of the old bonds when issued was their "true valuation * * * so far as plaintiff (Missouri Pacific) is concerned." The court held that for the purpose of income tax deduction for bond discount, bonds received in exchange for new bonds are in a completely separate category from other types of property received for the new bonds, and that the value of the old bonds so exchanged should be the amount received therefor by Missouri Pacific at the time they were issued, rather than their market value at the time of the exchange. In so doing, the court followed its decision in the Lackawanna case, where it held that the preferred stock of the Railroad Company was received by it in exchange for debentures; that the principal amount of the debentures was the same as that received for the preferred stock when issued; and it suffered no loss in the exchange and no discount was allowed

The two Court of Claims decisions supported the decision of the Tax Court in the instant case, but there is other respectable authority to the contrary. Moreover, the two Court of Claims decisions and the decision in the instant case, as we have heretofore shown, are based on an erroneous premise, namely, that the question is not whether there was a debenture discount which served the purpose of stated interest, but whether there was a loss suffered.

And we regard it as anomalous for the Department of the Treasury to hold in the instant case that National Alfalfa suffered no loss when it exchanged a $50 debenture for a share of preferred stock of the market value of $33, since it had received $50 for such share of preferred stock when it sold it, and to hold that the preferred stockholder realized a gain when he exchanged a share of preferred stock of a market value of $33 for a $50 debenture, when he paid $50

for such share of preferred stock when he purchased it.

It is firmly established by the adjudicated cases that where a corporation issues its bonds, including debenture bonds, which unconditionally oblige the corporation to pay the principal amount stated therein, together with interest thereon, at the times therein provided, and receives therefor the amount of the principal, less a discount, the amount of such discount is deductible as interest paid and should be amortized over the life of the bonds or debenture bonds.[3]

The reason for allowing the discount is that it represents the expense of borrowing. It serves "the same function as stated interest"[4] and "represents a part of the cost of the borrowed capital."[5]

The rationale stated above, with respect to the present treatment of discount as the same as interest paid on borrowed money, was followed and applied in a well considered opinion in *American Smelting & Refining Co. v. United States*, 3 Cir. [42-2 USTC ¶ 9670], 130 F. 2d 883. There, bonds were exchanged for preferred stock of a subsidiary of the issuer, when such issuer owned all of the common stock of such subsidiary. The market value of the preferred stock received by the issuer of the bonds was less than the principal of the bonds. The court there rejected the contention made in the instant case, and held that the difference between the sale value of the bonds and the market value of the preferred stock at the time of the exchange represented a discount and was deductible as interest amortized over the life of the bonds.

American Smelting was followed in two subsequent District Court cases in the Fifth and Seventh Circuits, respectively, in *Southern Fertilizer & Chemical Co. v. Edwards*, U. S. D. C. M. D. Ga. [55-1 USTC ¶ 49,133], 167 F. Supp. 879 (1955), and *Industrial Development Corp. v. United States*, D. Ill., 51 A. F. T. R. 1514, 56-2 USTC ¶ 10,066, (1956). Both cases involved the issuance of bonds in exchange for the issuer's preferred stock.[6]

In *Montana Power Company v. United States*, 3 Cir. [56-1 USTC ¶ 9402], 232 F. 2d 541, cert. den. 352 U. S. 843, the court, while disallowing the discount under the facts of that case, at page 546 reaffirmed its decision in the *American Smelting* case.

The case of *Atchison, Topeka and Santa Fe R. Co. v. United States*, 10 Cir. [71-1 USTC ¶ 9430], 443 F. 2d 147 (1971), which was an income tax refund suit, involved the reorganization of the then existing Atchison, Topeka and Santa Fe Railroad Company, hereinafter referred to as the "Old Company." The facts in that case were these:

On December 23, 1893, the Union Trust Company of New York, trustee under the first and second mortgage bonds of the Old Company, filed a complaint in the United States Circuit Court for the District of Kansas, requesting the appointment of a receiver for the properties of the Old Company. Receivers were appointed. On January 1, 1894, the Old Company defaulted in payment of interest on its general mortgage bonds. The Union Trust Company filed a second complaint on March 12, 1894, seeking foreclosure of the mortgage and sale of the railroad's property described in the mortgages. A reorganization took place in 1895, whereby the Atchison, Topeka and Santa Fe Railway Company, hereinafter referred to as the "New Company," the present plaintiff and taxpayer in the action, was organized and acquired all the assets of the Old Company.

After the filing of the first complaint by the Union Trust Company in 1893, bondholder protective committees were quickly formed throughout the country. The stockholders later established the Atchison Protective Reorganization Committee to protect their interests. Following various negotiations, three of the existing bondholder committees created the Joint Executive Reorganization Committee. After arm's length negotiations with the other groups of security holders, the Joint Executive Committee formulated and proposed a plan of reorganization for the Old Company, which was finally approved on April 10, 1895. It proposed the foreclosure of the general mortgage, also referred to as the first mortgage, and the vesting of the properties acquired at the foreclosure sale into the New Company.

[3] *Helvering v. Union Pacific Railroad Co.* [35-1 USTC ¶ 9011], 293 U. S. 282 (1934).
[4] *United States v. Midland-Ross Corp.* [65-1 USTC ¶ 9387], 381 U. S. 54, 57 (1965).
[5] *Helvering v. Union Pacific Railroad Co.* [35-1 USTC ¶ 9011], 293 U. S. 282, 287 (1934).
[6] See also *Nassau Lens Co. v. C. I. R.*, 2 Cir. [62-2 USTC ¶ 9723], 308 F. 2d 39, where in answer to the contention of the Commissioner that "when a seller also becomes a financing medium by taking bonds issued at a discount instead of cash in exchange for property, the tax laws will not recognize a charge for the use of money," the court stated: "We find no support for such an assertion and reject it. See *American Smelting & Ref. Co. v. United States* [42-2 USTC ¶ 9670], 130 F. 2d 883 (3rd Cir. 1942)."

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Under the plan, the general mortgage bondholders, the second mortgage bondholders, and the income bondholders of the Old Company were to place their respective securities in various depositories and receive in exchange therefor certificates of deposit; and the stockholders of the Old Company were to place their stock in various depositories and receive in exchange therefor certificates of deposit. Under the plan, the holders of the second mortgage bonds, of the income bonds, and of common stock were to pay a cash assessment totaling approximately $14,000,000 into a depository in order to be eligible to receive certificates of deposit and to participate in the plan.

The plan specified what the holders of securities of the Old Company, respectively, would receive in bonds, or bonds and preferred stock, of the New Company in exchange for their certificates of deposit, and what the stockholders of the Old Company should receive in common stock of the New Company in exchange for their certificates of deposit.

On August 27, 1895, the Union Trust Company filed a supplemental complaint in the Circuit Court, requesting that the properties of the Old Company be sold as a single parcel. The joint Executive Committee was allowed by the court to intervene in the reorganization proceedings, requested the Union Trust Company to go forward with the sale, and the court so ordered. A special master sold the property for $60,000,000 at a public auction on December 10, 1895, to Edward King, President of the Union Trust Company, Victor Marawetz, and Charles Beeman, all representing the Joint Executive Committee. The court approved the sale on the same day, decreeing that the purchasers could transfer the property to a new corporation, subject to certain restrictions, including provision for paying certain general mortgage bondholders of the Old Company who had elected not to participate in the plan.

The next day, December 11, 1895, the property was deeded to the three men. On December 12, 1895, the Joint Executive Committee incorporated the New Company, and the three men deeded the properties to it. The purchase price recited in the deed was $382,202,500, payable as follows: $96,990,500 par value of the New Company's general mortgage bonds; $51,728,000 par value of the New Company's adjustment mortgage bonds; $131,486,000 par value of the New Company's preferred stock; and 1,019,980 shares ($101,998,000 par value) of the New Company's common stock. The New Company delivered these securities and stock to the Joint Executive Committee, which placed them in the Union Trust Company. The Trust Company eventually effected the exchange of the old certificates of deposit for the securities of the New Company.

The basis of the New Company's claim for an income tax refund was that it issued general mortgage and adjustment bonds in exchange for the intangible claims of the general mortgage bondholders of the Old Company; that the fair inherent value of such claims was less than the par value of taxpayer's bonds issued in exchange therefor, and that such difference constituted discount amortizable for federal income tax purposes.

At the trial below, the court ruled that in substance the bonds of the New Company were exchanged for the bonds of the Old Company, and submitted to the jury the questions of whether the fair market value of the bonds received was less than the par value of the bonds paid, and whether such difference constituted amortizable bond discount. The jury found a difference of $56,480,548, and decided that such amount constituted original issue discount.

This court held that the last step in the transaction determined the substance of what had occurred, and that the New Company issued its general mortgage and adjustment bonds in exchange for the intangible claims of the general mortgage bondholders of the Old Company; that the fair inherent value of such claims was less than the par value of the taxpayer's bonds issued in exchange therefor, and that such difference constituted discount amortizable as interest paid for federal income tax purposes. The court said:

> "Clearly the taxpayer would have been entitled to a deduction for discount had the bonds been sold on the market at a discount, and the proceeds used to purchase the assets of the Old Company."

The court further held that there was no difference in substance between that and what actually happened in the reorganization proceeding, and cited the *American Smelter Company* case, in which it was said:

> "We believe that the discount is still to be treated as additional interest when the subject matter of the loan is stock instead of cash."

The court further stated:

"This view conforms with economic and business reality which recognizes that to the issuer bond interest is reflected both by the stated rate of interest and by the amount below or above par received by the issuer when the bonds are originally distributed. The taxpayer in this case presented substantial evidence from experts in railroad securities and properties who relied on the documents surrounding the reorganization, market conditions and actual trading, and valuation of the railroad properties as establishing the economic basis for and probable existence of discount * * *"

and affirmed the judgment of the lower court.

[*Conclusion*]

We repeat that we are of the opinion that the decisions of the Tax Court and of the Court of Claims are predicated on an unsound premise when they hold that whether or not deductions shall be allowed, because of discount as interest paid, depends on whether the taxpayers claiming such deductions suffered a loss in the transactions.

We hold, because it is now settled by the decisions of the Supreme Court, that the deduction is for interest charged by reason of a discount, and not as a loss suffered by the taxpayer.[1]

The decision of the Tax Court sustaining the deficiency assessed by the Commissioner against National Alfalfa for its tax year ending April 30, 1967, and holding that there was a deficiency in income tax due from National Alfalfa for such tax year of $147,949.76 is REVERSED;

And the case is REMANDED, with instructions to direct the Commissioner to allow National Alfalfa to deduct from its gross income for such tax year that portion of the total debenture discount which is deductible as interest paid, amortized, or prorated over the life of the debentures, 18 years, allocable to such tax year ending April 30, 1967; and also to deduct an amount for loss carryovers from prior years, in view of our holding that the debenture discount was deductible as interest paid, amortized over the life of the debentures, provided National Alfalfa was entitled to take a deduction in its return for its tax year ending April 30, 1967, for losses suffered in prior years, a question not raised nor passed on by this court on this appeal.

[Dissenting Opinion]

HILL, Circuit Judge, dissenting:

No. 72-1125 National Alfalfa Dehydrating and Milling Company v. Commissioner of Internal Revenue.

I am compelled to respectfully dissent from the majority opinion. My colleagues, in rejecting certain cases, in my opinion have done so on the basis of a rule of law gleaned entirely out of context when viewed with other cases in which this same problem is confronted.

The majority reject *Erie Lackawanna Railroad Company v. United States* [70-1 USTC ¶ 9245], 422 F. 2d 425 (Ct. Cl. 1970), and *Missouri Pacific Railroad Company v. United States* [70-1 USTC ¶ 9457], 427 F. 2d 727 (Ct. Cl. 1970), *modified*, [70-2 USTC ¶ 9608] 433 F. 2d 1321 (Ct. Cl. 1970), *cert. denied*, 402 U. S. 944, on the basis that those cases "are based on an erroneous premise, namely, that the question is not whether there was a debenture discount which served the purpose of stated interest, but whether there was a loss suffered." I agree with the majority to the extent that loss is not synonymous with discount, but rather that discount "serves 'the same function as stated interest' and 'represents a part of the cost of the borrowed capital.'" I must conclude, however, the concept of loss as used in those cases is correct when read in context with other cases.

In *St. Louis—San Francisco Railway v. United States* [71-2 USTC ¶ 9544], 444 F. 2d 1102, 1106 (Ct. Cl. 1971), *cert. denied*, 404 U. S. 1017, the court there rejected any discount in either of two exchanges on the basis "that there was an exchange of equals." In analyzing its decision in *Erie Lackawanna*, the court stated discount was not allowed in that case because "equivalents had been exchanged and no discount could be said to arise." When loss is thus analyzed in the context of whether there was a disparity in values in an exchange, those

[1] We are also of the opinion that the case of *Claussen's, Inc. v. United States*, 5 Cir., [72-2 USTC ¶ 9751] — F. 2d —, (decided November 16, 1972, 41 LW 2278) is clearly distinguishable on the facts from the instant case. In that case, the corporation involved not only issued its bonds in exchange for its outstanding Class A and Class B common stock, but also issued its new common stock to each of its old holders of Class A and Class B common stock, in direct proportion to their original equity interest in the corporation. The court held that the common stockholders' equitable posture relative to the corporation and to one another after the exchange was substantially the same as it was before the exchange, and hence no bond discount arose.

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cases rejected by the majority are clearly authoritative.

A further example of application of this "equivalency of exchange" formula is provided in *Cities Service Company v. United States* [70-2 USTC ¶ 9537], 316 F. Supp. 61 (S. D. N. Y. 1970). In that case there was a disparity in values in an exchange of debentures for preferred stock due to the higher value of the debentures being offered in exchange. The court there allowed discount measured by the amount of that disparity. That excess represented the true additional consideration which the company was required to pay in retiring its outstanding preferred stock.

The cases cited applying the equivalency of exchange formula have uniformly held that where the corporation is retiring its own outstanding bonds or stock in an exchange transaction, the value to be ascribed those outstanding bonds or stock shares is the value originally received by the corporation in exchange for that outstanding obligation. I am not persuaded that the cases cited in the majority opinion require fair market value to be ascribed the outstanding obligations, as those cases are distinguishable. Both *Atchison, Topeka and Santa Fe Railway Co. v. United States* [71-1 USTC ¶ 9430], 443 F. 2d 147 (10th Cir. 1971), and *American Smelting & Refining Co. v. United States* [42-2 USTC ¶ 9670], 130 F. 2d 883 (3d Cir. 1942), involved corporations exchanging their debt obligations for the outstanding obligations of another corporation. In both cases, the corporation assuming the outstanding obligations was not the corporation which had originally received the consideration for those obligations. This distinction was noted in *Erie Lackawanna, supra*, and remains viable today, although apparently modified to the extent that the value of outstanding obligations of a subsidiary, when assumed by the parent corporation, is the consideration originally received by the subsidiary rather than the market value of the outstanding obligation.[1] Market value is therefore revelant only when the assuming corporation is other than the corporation which originally issued the obligation.

I would note also that *Southern Fertilizer & Chemical Co. v. Edwards* [55-1 USTC ¶ 49,133], 167 F. Supp. 879 (M. D. Ga. 1955), and *Industrial Development Corp. v. United States*, 51 A. F. T. R. 1514, 56-2 USTC ¶ 10,066 (D. Hl. 1956), on which the majority rely, contain only findings of fact and conclusions of law with no detailed discussion of the question. I therefore, as did the court in *Erie Lackawanna*, reject those cases as authoritative. I likewise distinguish *Montana Power Company v. United States* [56-1 USTC ¶ 9402], 232 F. 2d 541 (3d Cir. 1955), *cert. denied*, 352 U. S. 843, on the facts, as the issue presented there related to proof of value of property originally exchanged for the corporate obligation. We are here confronted with an exchange of a subsequent corporate obligation for a prior obligation.

My close reading of the cases reveals a formula to be followed when a corporation issues its debt obligation in exchange for its own prior outstanding obligation. In applying this formula, the value assigned the outstanding obligation is the consideration received by the corporation when originally issued. Any discount, therefore, is dependent on a showing of disparity in values reflected by the higher value of corporate debt obligation given in exchange. If there is no disparity in value, that is, if there is an equivalency in the exchange, no discount arises. The facts here clearly show only equivalent exchanges. I would, therefore, affirm the decision of the Tax Court.

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[1] *See Missouri Pac. R. R. Co. v. United States* [70-1 USTC ¶ 9157], 427 F. 2d 727 (Ct. Cl. 1970), *modified*, [70-2 USTC ¶ 9698] 433 F. 2d 1324 (Ct. Cl. 1970), *cert. denied*, 402 U. S. 944.

APPENDIX D

In the United States Court of Claims

No. 289-65
No. 303-66

(Decided December 12, 1972)

ST. LOUIS-SAN FRANCISCO RAILWAY COMPANY v. THE UNITED STATES

Robert E. Simpson for plaintiff. ***Robert T. Molloy***, attorney of record. ***George E. Bailey***, of counsel.

Frances Folts Kane, with whom was ***Assistant Attorney General Scott P. Crampton***, for defendant. ***Fred B. Ugast***, of counsel.

Before COWEN, *Chief Judge*, DAVIS, SKELTON, NICHOLS, KASHIWA, KUNZIG, and BENNETT, *Judges*.

ON PLAINTIFF'S MOTION FOR SUMMARY JUDGMENT AND DEFENDANT'S CROSS-MOTION FOR PARTIAL SUMMARY JUDGMENT

COWEN, *Chief Judge*, delivered the opinion of the court:

In our decision of July 14, 1971 (herein referred to as *St. Louis No. 1*), in these related tax cases, we decided several issues relating to the measurement of debt discount claimed as the result of the exchange of new debt obligations for outstanding debt obligations and outstanding stock. *St. Louis-San Francisco Ry.* v. *United States*, 195 Ct. Cl. 343, 444 F. 2d 1102 (1971), *cert. denied*, 404 U.S. 1017 (1972). The parties' pending cross-motions for summary judgment require us to decide two additional issues that were not raised in the earlier decision and one which both parties now agree is governed by *St. Louis No. 1*.

I

The Reduction of Basis

In *St. Louis No. 1*, we held that because plaintiff had failed to raise the reduction-in-basis issue (as it relates to depreciable property) in its claim for refund, it could not assert the claim on motion for summary judgment. However, this holding did not foreclose plaintiff from asserting the claim as an offset to offsets claimed by defendant. Plaintiff was allowed to file an amended reply to defendant's first amended answer, and plaintiff's current motion is based on this newly pleaded issue.

In 1959, 1960, and 1962, plaintiff reacquired a portion of the debentures that it had issued in 1956 in exchange for outstanding preferred stock. Upon audit, the IRS determined that the reacquisition resulted in a gain, but plaintiff elected to have the gain excluded from its income pursuant to Section 108(a) of the Internal Revenue Code of 1954.[1]

Plaintiff executed Treasury Consent Form 982, which is a prelude to the reduction in the tax basis of certain property to the extent of the unrecognized gain. Section 1017 of the Internal Revenue Code of 1954 is the statutory authority for this reduction.

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[1] SEC. 108. INCOME FROM DISCHARGE OF INDEBTEDNESS.

(a) *Special Rule of Exclusion.*—No amount shall be included in gross income by reason of the discharge in whole or part, within the taxable year, of any indebtedness for which the taxpayer is liable, or subject to which the taxpayer holds property, if—

(1) the indebtedness was incurred or assumed

(A) by a corporation, or

(B) by an individual in connection with property used in his trade or business, and

(2) such taxpayer makes and files a consent to the regulations prescribed under section 1017 (relating to adjustment of basis) then in effect at such time and in such manner as the Secretary or his delegate by regulations prescribes.

In such case, the amount of any income of such taxpayer attributable to any unamortized premium (computed as of the first day of the taxable year in which such discharge occurred) with respect to such indebtedness shall not be included in gross income, and the amount of the deduction attributable to any unamortized discount (computed as of the first day of the taxable year in which such discharge occurred) with respect to such indebtedness shall not be allowed as a deduction.

[We note that § 108(b) does not apply since this was not a discharge, cancellation, or modification affected by an order of a court in a receivership proceeding.]

Plaintiff desired to have the basis of the preferred stock reduced but was rebuffed by the Commissioner. In *St. Louis No. 1* we held that the Commissioner's ruling was correct, because the preferred stock was no longer in existence for the years 1959, 1960, and 1962. The Commissioner did allow a reduction in basis of plaintiff's depreciable property but restricted the reduction to ratably depreciable property. By "ratably depreciable property", we understand that defendant means the kind of property in which the cost or other basis is ratably spread over its estimated useful life during which annual deductions for depreciation are made in accordance with some accounting method such as the straight-line method. In addition to its ratably depreciable property, plaintiff also owns non-ratably depreciable property, *e.g.*, track and rails. Plaintiff depreciates these items by the use of retirement-replacement-betterment method of depreciation (herein referred to as RR&B method). Recently, we had occasion to review the definition and application of the RR&B method in *Chicago, Burlington & Quincy R.R. v. United States*, 197 Ct. Cl. 264, 455 F. 2d 993 (1972), *cert. granted*, 409 U.S. — (1972). Consequently, we will not repeat that discussion except to the extent necessary to the decision in this case.

The basis adjustment regulation upon which taxpayer asserts its offset was promulgated at the behest of Congress when the predecessor to section 1017 was made a permanent provision in 1951.[2] It would be difficult to imagine a broader delegation of the legislative prerogative than the authority granted to the Secretary in this instance:

> SEC. 1017. DISCHARGE OF INDEBTEDNESS.
>
> Where any amount is excluded from gross income under section 108(a) (relating to income from discharge of indebtedness) on account of the discharge of indebtedness the whole or a part of the amount so excluded from gross income shall be applied in reduction of the basis of *any* property held (whether before or after the time of the discharge) by the taxpayer during any portion of the taxable year in which such discharge occurred. *The amount to be so applied* (not in excess of the amount so excluded from gross income, reduced by the amount of

[2] Revenue Act of 1951, ch. 521, § 304, 65 Stat. 452.

> any deduction disallowed under section 108(a)) *and the particular properties to which the reduction shall be allocated, shall be determined under regulations (prescribed by the Secretary or his delegate) in effect at the time of the filing of the consent by the taxpayer referred to in section 108(a)* * * *. [Emphasis added.]

The anticipated amendment to the regulation was promulgated on April 2, 1953,[3] and is represented in applicable part by the current regulation § 1.1017–1(b)(7):

> Any reduction in basis which remains to be taken (by reason of an exclusion from gross income under section 108(a)) after the application of paragraph (a)(1) of this section *shall be applied first against property of a character subject to the allowance for depreciation under section 167* * * *. [Emphasis added.]

There is no doubt that the RR&B method of accounting is an acceptable method for depreciating property under section 167 of the Code, and defendant conceded that fact in oral argument. Approval of this method of accounting by the Internal Revenue Service has been an established fact at least since 1940 when the Seventh Circuit decided *Chicago & North Western Ry.* v. *Commissioner*.[4] *The Boston & Maine R.R.* v. *Commissioner*[5] case, decided three and one-half months after the above-quoted regulation was promulgated, again approved this method as an acceptable method under the provisions of the predecessor to section 167. Additionally, in Revenue Ruling 67–22, the Commissioner stated that "both the railroad industry and the Internal Revenue Service use 'retirement method' to mean a method of accounting for depreciation."[6]

That would seem to end the matter. Since it is undisputed that the taxpayer's RR&B property is of the "character subject to the allowance for depreciation under section 167," the basis of such property is qualified for reduction under section 1017.

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[3] T.D. 6003 (1953 CUM. BULL. 24) (Treas. Regs. 111 (1939 Code), § 29.113(b)(3)-1(G)).

[4] 114 F. 2d 882 (7th Cir. 1940), *cert. denied*, 312 U.S. 692 (1941). In this decision, it was the Government that relied on the method as the proper method of depreciation.

[5] 206 F. 2d 617 (1st Cir. 1953).

[6] 1967-1 CUM. BULL. 52.

However, defendant would have us re-write its regulation to differentiate between ratably and non-ratably depreciable property, both of which are of a "character subject to the allowance for depreciation under section 167." The Government contends that while the RR&B method is an appropriate method for use under section 167 in other circumstances, the allowance of plaintiff's claimed reduction in the basis of RR&B property would be contrary to the intent of Congress as revealed in the Senate Report accompanying the Revenue Act of 1951. The Senate Report [7] states in pertinent part:

> The Secretary of the Treasury has authority under section 113(b)(3) [section 1017 of the 1954 Code] to prescribe regulations which will set forth rules under which the adjustment to basis shall be made * * *. In order to assure that the exclusion of income by operation of section 22(b)(9) [section 108(a) of the 1954 Code] may result only in a temporary postponement of the tax liability, your committee understands that the Secretary of the Treasury will require by regulations that, after adjustment of the basis of certain property acquired with the purchase money indebtedness, whatever reduction in basis of property remains to be taken under section 113(b)(3) will be taken, *in general*, against depreciable property or property subject to cost depletion and only as a last resort against nondepreciable property. Thus, in general, it is intended that a reduction in the basis of nondepreciable property will be made only after the exhaustion of depreciable property or property subject to cost depletion. This provision will assure the collection within a reasonable time of the taxes postponed and will, therefore, have no appreciable long-run effect on the revenue. [Emphasis added.]

After a careful reading of the Senate Report, we cannot agree with defendant's contention that Congress clearly intended that the proposed regulation would apply only to ratably depreciable property. Furthermore, we find no support for defendant's argument that the RR&B method was not considered a method of depreciation at that time and was not comprehended by the regulation. It is true that the Senate Committee understood that the regulation would distinguish

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[7] S. REP. No. 781, 82d Cong., 1st Sess. 59-60 (1951-2 CUM. BULL. 458, 500).

between depreciable and non-depreciable property and that Congress intended that a reduction in the basis of nondepreciable property would be made only after the exhaustion of depreciable property. The statement was also made that a regulation containing such a provision would assure the collection of the postponed taxes in a reasonable time and would have no appreciable long-run effect on the revenue. However, no reference whatever was made to non-ratably depreciable property, and there is no indication that the Senate Committee had its attention called to or considered in any way the interpretation of the regulation which defendant now urges upon us.

In contrast to the lack of any expression of the congressional intention with respect to the precise issue before us, we have the very broad delegation of legislative authority to the Secretary of the Treasury under the provisions of section 1017. The regulation in issue is a legislative regulation, which is the statute itself. It is to be differentiated from an interpretative regulation, which is one that rephrases the statute to give it body.[8] The adoption of defendant's interpretation would require a redrafting of the regulation, excluding any reference to section 167. We find nothing in the legislative history which authorizes or requires us to take that action.

In promulgating the regulation, the Internal Revenue Service adopted a shorthand method of dealing with a complex problem. It used a rational approach by the reference to section 167. An amendment of this legislative regulation to conform with defendant's arguments would require congressional hearings, or at least compliance with established Internal Revenue Service procedure for changes in the regulations and a careful weighing of the ramifications of proposed changes on various types of depreciable property.

The defendant argues that except where there is a complete abandonment or retirement of track without replacement, the tax lost as a result of the reduction in the basis of such property will not be recouped. The result, the defendant says, is to thwart the congressional purpose of avoiding an appreciable long-run effect on the revenue. It is true that only a small portion of railroad track or rails is retired every year, but

[8] *See* Griswold, *A Summary of the Regulations Problem*, 54 HARV. L. REV. 398, 401 (1941).

more of this property is retired in some years than others. All of this is contemplated by section 167 for, as the court said in *Boston & Maine R.R.* v. *Commissioner, supra:*

> * * * [T]he underlying theory of the retirement method is that the charges to expense on account of all the items retired or replaced in any particular year are taken as a rough equivalent of what would be a proper depreciation allowance for *all* the working assets of the company for that year. The assumption is that once the system is functioning normally and the retirements are staggered fairly regularly, the charges to expense on account of equipment wearing out or otherwise disappearing from service are spread out and stabilized, and hence will approximate the results under straight-line depreciation. [9] * * *

Long range effects on the revenue are also brought about when there is a reduction in the basis of ratably depreciable property that has a useful life of more than 50 years. We believe that the Treasury had this in mind when it issued the regulation before us. We must also presume that the Treasury knew that RR&B property was of a "character subject to the allowance of depreciation under section 167." After all, the *Chicago & North Western* case had been decided 13 years earlier. *Boston & Maine*, decided a little over 3 months after the regulation was promulgated, was a signal that the regulation would have to be amended if it were to mean something other than what is clearly expressed by its terms. The fact that the regulation has remained unchanged for 19 years is, it seems to us, an indication of an administrative determination that when all the factors involved are considered, the use of the section 167 approach is the best means of carrying out the intent of Congress.

The use of the section 167 approach also gives a degree of certainty in an area where the need for certainty is high. As Professor Eustice points out:

> The dictates of practical administration of the tax laws demand a reasonable degree of certainty in their application, especially where a problem cuts across so many phases of business and personal activity as does the debt cancellation situation.[10]

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[9] 206 F. 2d at 619.

[10] Eustice, *Cancellation of Indebtedness and the Federal Income Tax: a Problem of Creeping Confusion.* 14 TAX L. REV. 225 (1959).

In summary, we hold that the regulation, unamended by the interpretation which defendant advocates, conforms to the intent of Congress. If a line is to be drawn between ratably depreciable property and non-ratably depreciable property, as defendant argues, it would be equally logical and necessary to provide a distinction between short-lived ratably depreciable property and similar property having a very long estimated useful life. In view of the clear and unambiguous language of the regulation, the fact that it has remained unchanged for so many years, and the long history of approval of the RR&B method under section 167 and its predecessors, plaintiff had a right to rely on the regulation according to its terms. Since plaintiff's claim meets the requirements of section 1017, section 167, and the regulation, plaintiff is entitled to the offsets now claimed.

II

Unamortized Debt Discount Carryover

In the 1947 reorganization, plaintiff's outstanding common and preferred stocks were eliminated as worthless. The outstanding debt was cancelled and the holders of the several classes of indebtedness received new bonds, preferred and common stock, and cash in satisfaction of their claims against plaintiff. After an audit of plaintiff's tax returns for 1947 and 1948, the Internal Revenue Service allowed the taxpayer to carry over unamortized discount and expense from its old bonds allocated to its new bonds, in the amount of $1,643,610.82. For the years in suit, the amortized deductions amounted to more than $23,000 per year.

As an offset, defendant now urges that the Service's action in allowing the carryover was erroneous. We agree. This issue is governed by our decision in *Chicago, Milwaukee, St. Paul and Pacific R.R.* v. *United States*, 186 Ct. Cl. 250, 404 F. 2d 960 (1968). In that case, we held that issuance expense would be treated as would discount, and this being so, there could be no carryover of debt discount or issuance expense if the maturity value of the new bonds is less than the amount that was received when the old securities were issued.

We also held that when common or preferred stock is substituted for a debt, the principal of the debt is no longer

to be paid at a fixed future date. Therefore, the discount and issuance expense attributable to the issuance of the old debt for which the stock is substituted is not deductible after the substitution is made.

It is established in this case that the net amount which plaintiff received upon the issuance of the old debt obligations that were cancelled in the 1947 reorganization was substantially greater than the total maturity value of the new bonds issued in exchange for the old obligations. In the 1947 reorganization, plaintiff also issued preferred and common stock having a par or stated total value of $120,763,545. Although the value of the stock is not to be computed in determining entitlement to the unamortized discount, computations based on the admission of the parties show that the addition of the value of the stock to the maturity value of the new bonds produces a total which is still considerably less than the amount received for the old bonds. The cash which plaintiff paid for interest due on the old debt in the 1947 reorganization is likewise not to be taken into account, because it was issued in a one-for-one exchange.

As its final argument on this issue, plaintiff urges that we should reconsider our decision in *Chicago, Milwaukee* because it is in possible conflict with *Southwest Grease & Oil Co.* v. *United States*, 308 F. Supp. 107 (1969), modified in part, 435 F. 2d 675 (10th Cir. 1971). We think plaintiff misreads *Southwest*. In that case the taxpayer redeemed outstanding bonds at a premium, whereas here, plaintiff redeemed its old bonds at substantially less than the net amount received when the old bonds were issued. For each $1,000 bond, Southwest gave $1,290 in cash and new bonds. Therefore, deductions were allowed for both the premium and the issuance expense of the old bonds. This is totally different from the instant cases where taxpayer's new debt was substantially *less* than the old debt. The substantially lower new debt extinguished the discount, and as we said in *Chicago, Milwaukee*, "[t]here was nothing left to amortize."

Since the allowance of the carryover of the unamortized discount and expense was erroneous, plaintiff's recovery in

these cases should be reduced by the amount of the erroneous allowances.

III

Original Issue Discount

In its motion for partial summary judgment in *St. Louis No. 1*, plaintiff claimed original issue discount for the years 1955, 1956, 1959, 1960 and 1961. In its reply to defendant's first amended answer in Docket No. 289-65, plaintiff alleged that it was entitled to original issue discount deductions for each of the years 1947 through 1955. Plaintiff now agrees that the issue with respect to the additional years mentioned was determined in defendant's favor by our decision in *St. Louis No. 1*. Therefore, defendant's motion for partial summary judgment on this question should be granted.

Conclusion

Plaintiff's motion for summary judgment on Issue I is granted, and defendant's motion for partial summary judgment on Issues II and III is granted. The cases are remanded to the trial commissioner pursuant to Rule 131(c) for further proceedings consistent with this opinion.

DAVIS, *Judge*, dissenting in part:

I join with the court on "Unamortized Debt Discount Carryover" (Part II) and "Original Issue Discount" (Part III) but diverge on "The Reduction of Basis" (Part I). The latter question is very close. The court relies most heavily on the literal wording of the regulation which can easily be read without strain in the taxpayer's favor, as the court does. The counterforce, for me, is the overall purpose of Congress, in §§ 108 and 1017, not to put off indefinitely the taxation of gain from the reacquisition of corporate indebtedness.

The 1951 Senate Committee report (S. REP. No. 781, 82d Cong., 1st Sess. 59-60, 1951-52 CUM. BULL. 458, 500), quoted in the majority opinion, indicates that the "exclusion of income by operation of section 22(b)(9)" [now § 108(a)] should "result only in a temporary postponement of the tax liability", and that placing the exhaustion of nondepreciable

property after the exhaustion of depreciable property (or property subject to cost depletion) "will assure the collection within a reasonable time of the taxes postponed and will, therefore, have no appreciable, long-run effect on the revenue." Under plaintiff's system of retirement accounting, that goal will not be at all achieved. The taxes postponed will not be collected in substantial measure unless the track and rails are wholly abandoned without replacement (an unlikely event as to any major segment of the road), or the railroad goes out of business (and in the latter case, as defendant points out, the company is unlikely to have any taxable income).[1] In other words, because the replacement of rails and tracks is expensed annually and the railroad does not use depreciation deductions as a means of gradually recouping the cost of those items, the basis-reduction sought by the taxpayer will not have the effect Congress envisaged of simply extending for a reasonable period the taxation of the gain on the reacquisition of the preferred stock, but will rather result in the indefinite postponement of most of the tax on that gain (with a good chance that it will never be taxed).

The court points out, in answer, that in the ratable system of depreciation many properties have a useful life of 50 years or more, hardly a temporary period. But the difference is that in those instances the reduction in basis, under the regulation, would lead at once to a pro rata reduction in the annual depreciation deductions, and thus to a gradual but continuous recovery of the postponed tax. Under plaintiff's view, there would be no such steady (though extended) payment of the tax.

In this light, the wording of the regulation does not seem to me to be decisive. Although we now consider the retirement-replacement-betterment system a general system of tax depreciation, that was not so clear in early 1953 when the regulation was promulgated. The broad language

[1] For its track and rails, the plaintiff does not reduce its income tax by depreciation deductions (which, of course, are intimately related to the basis of the property being depreciated) but by full deductions for replacements as if they are repairs (and for retirement if the property is permanently retired without replacement). The calculation of the replacement deductions has no necessary connection with the basis of the particular property; a reduction in basis under the regulation will therefore not reduce the allowable deductions.

of *Boston & Maine R.R.* v. *Commissioner*, 206 F. 2d 617 (C.A. 1, 1953), was not yet on the books, and in the litigation of that case the Revenue Service obviously did not consider the retirement system a method of depreciation for all tax purposes. True, *Chicago & North Western Ry.* v. *Commissioner*, 114 F. 2d 882, 885-86 (C.A. 7, 1940), *cert. denied*, 312 U.S. 692 (1941), had accepted, over the railroad's protest, the Service's designation of the retirement system as a proper method of computing depreciation deductions under the predecessor of § 167, but that did not necessarily mean that rails and tracks were "property of a character subject to the allowance for depreciation" (the terms of the regulation now involved). There could be different characterizations for different purposes. The Service may have been thoughtless in letting this language remain unqualified after the *Boston & Maine* opinion, but that neglect does not override, in my opinion, the indications that neither the Congress nor the Treasury expected the regulation to be applied as plaintiff would have it.

Nor does it not seem to me stretching the words too far to exclude (because the purpose so requires) the plaintiff's replacement system for rails and track. The literal language is not that compelling or rigid. It is possible, in this setting, to read a "reduction in basis" to be applied "first against property of a character subject to the allowance for depreciation under section 167" as limited to property the basis of which is significant in the computation of the depreciation deduction and, conversely, as designating replaced property as not "of a character subject to the allowance for depreciation."

In sum, I deem fulfillment of the legislative goal in this particular context as more important than adherence to the normal understanding, in other contexts, of the general language of the regulation, and believe that there is an acceptable reading of the regulation which advances rather than negates the Congressional aim.

NICHOLS, *Judge*, joins in the foregoing dissenting opinion.

In the United States Court of Claims

No. 289-65

No. 303-66

(Decided July 14, 1971)

ST. LOUIS-SAN FRANCISCO RAILWAY COMPANY v. THE UNITED STATES

George K. Dunham, for plaintiff. *Robert T. Molloy*, attorney of record. *George E. Bailey* and *Robert E. Simpson*, of counsel.

E. Alan Moorhouse, with whom was *Assistant Attorney General Johnnie M. Walker*, for defendant.

Before COWEN, *Chief Judge*, LARAMORE, DURFEE, DAVIS, COLLINS, SKELTON, and NICHOLS, *Judges*.

ON PLAINTIFF'S MOTION FOR SUMMARY JUDGMENT RESPECTING THE DEBT DISCOUNT ISSUE AND DEFENDANT'S CROSS MOTION FOR PARTIAL SUMMARY JUDGMENT

COWEN, *Chief Judge*, delivered the opinion of the court:

These cases come before the court on cross-motions for partial summary judgment. Plaintiff is seeking tax refunds for the years of 1953 through 1961. At issue in this proceeding are the years 1955 through 1961. The main question before us now is the troublesome one of the existence and measurement of debt discount when a corporation exchanges new debt obligations for its outstanding debt obligations and its outstanding stock. Since two exchanges are involved, we will consider each separately before discussing the other issues raised in the parties' motions.

I

The 1947 Reorganization

In 1947 plaintiff St. Louis-San Francisco Railway Company underwent a reorganization pursuant to Section 77 of the Bankruptcy Act.[1] Under the plan adopted, plaintiff exchanged new stock, new bonds, and cash for outstanding bank loans, bonds, and accrued interest.[2] Before the exchange, the face value of this outstanding debt and interest totaled $363,789,651. Plaintiff gave up in the exchange securities having a maturity value and a par value of $244,856,494. The aggregate maturity value of the new bonds totaled $120,935,000, and their market value, as established by New York Stock Exchange quotations, totaled $91,866,411. A schedule of the reorganized company shows that in no instance did the face value of the bonds issued exceed the principal amount of the old debt. See *McCullough* v. *United States*, 170 Ct. Cl. 1, 24-25, 344 F. 2d 383, *cert. denied*, 382 U.S. 901 (1965). Plaintiff tells us that the market value of the old debt equaled $91,866,411. The figure was apparently computed on plaintiff's assumption that fair market value equivalents were exchanged.

Plaintiff contends that it is entitled to amortize the difference between the maturity value of the new bonds and the fair market value of old debt as debt discount. This difference, according to plaintiff, would be $29,068,089, amortizable over the life of the bonds. Plaintiff relies on Treasury Regulation 1.163-3 and *American Smelting & Ref. Co.* v. *United States*, 130 F. 2d 883 (3rd Cir. 1942). In the alternative, plaintiff argues that a trial would be necessary if we adhere to our decisions in *Erie Lackawanna R.R.* v. *United States*, 190 Ct. Cl. 682, 422 F. 2d 425 (1970) and *Missouri Pac. R.R.* v. *United States*, 192 Ct. Cl. 318, 427 F. 2d 727 (1970), *modified on reconsideration*, 193 Ct. Cl. 257, 433 F. 2d 1324 (1970), *cert. denied*, 39 U.S.L.W. WEEK 3486 (May 3, 1971).

On the other hand, defendant says that fair market value is irrelevant when the corporation exchanges its own debt

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[1] Plaintiff is an accrual basis taxpayer for the years in question.

[2] Claims of the common and preferred stockholders and unsecured creditors were eliminated from the capital structure as worthless.

obligations. Defendant further contends that no trial is necessary, because the undisputed facts establish that no discount arose in the exchange. For both arguments, defendant relies on *Missouri Pacific, supra.*

After a review of our decisions in *Erie Lackawanna* and *Missouri Pacific*, we find no reason to change the rules set forth in those cases with respect to the existence and measurement of debt discount when a corporation issues new bonds in exchange for its outstanding debt. In this case, the plaintiff engaged in a reorganization—a recapitalization in which no new capital or assets were added. The secured creditors received new bonds, preferred stock, common stock and cash. The maturity value of the new bonds was less than the face value of the old bonds.

In *Missouri Pacific, supra.* we held contrary to the position now taken by plaintiff with reference to the use of fair market value for measuring debt discount. In that case, we said "The fact that the fair market value of the old bonds may be less than the face value of the new bonds can in no way reduce the amount of value originally paid to plaintiff for the old securities." 192 Ct. Cl. at 321, 427 F. 2d at 731. Applying the rule announced in that case, we find that no debt discount arose in the 1947 reorganization, because the maturity value of the new debt did not exceed the maturity value of the old debt. There is no dispute about that fact and thus no trial is necessary. Since plaintiff incurred no discount in the issuance of the new bonds in the 1947 reorganization, it is entitled to no deductions for the claimed discounts during the years in suit.[3]

II

The 1956 Exchange

In 1956 plaintiff exchanged Series A. five percent Income Debentures bearing a maturity date of January 1, 2006, plus cash and common stock for its outstanding Series A. five percent Preferred Stock, issued in the 1947 reorganization.

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[3] On the assumption that the bonds issued in 1947 were issued at a discount, plaintiff makes certain additional claims. However, we need not consider these, because plaintiff concedes (page 26 of its Reply Brief) that a decision that the bonds were not issued at a discount precludes recovery on the additional claims.

For each $109 par value share of preferred stock surrendered, the holders of the preferred stock received a $100 maturity value Series A Debenture, one quarter share of common stock, and cash amounting to the unpaid portion of the dividend on the preferred stock.

In the aggregate, plaintiff exchanged debentures having a face value of $33,129,000 and 82,823 shares of no par common stock for 331,290 shares of preferred stock which had a total par value of $33,129,000. The market value of the preferred stock, based on New York Stock Exchange quotations, averaged $22,908,118.35 over the period of the exchange. After the exchange was completed, the preferred stock was cancelled and retired.

This transaction was considered by the Internal Revenue Service a reorganization under Section 368(a)(1) of the Internal Revenue Code of 1954—a recapitalization under section 368(a)(1)(E).

In claiming that the 1956 exchange gave rise to amortizable debt discount, plaintiff's primary contention is that the fair market value of the preferred stock ($22,908,118.35) subtracted from the maturity value of the debentures ($33,129,000) is the measurement of debt discount. Thus, plaintiff has computed an amortizable discount of $10,220,881.65.

Plaintiff does not contend that the maturity value of the debentures issued in 1956 exceeded the amount it received when it issued the preferred stock in the 1947 reorganization. Indeed, the facts show that in the 1947 reorganization, plaintiff issued the preferred stock (received in the 1956 exchange), plus common stock and two issues of new bonds having a combined maturity, par, or stated value of approximately $244,856,000 in satisfaction of claims totaling $363,789,000—an amount which exceeded the par and stated value of the stock and bonds issued in 1947 by more than $100,000,000.

The question as to whether original debt discount arises when there is an exchange of debt for equity has been before the court twice in recent years. In *Erie Lackawanna*, we rejected the use of fair market value as a determinative measurement of debt discount when bonds were exchanged for preferred stock. The key element in that case was the *value*

to the corporation of the stock received in the exchange and that value was what had been paid in for the stock. Since the preferred stock in that case had been issued in exchange for the cancellation of debt equal to the par value of the stock, we held that when $100 par value shares were exchanged for $100 maturity value debentures, equivalents had been exchanged and no discount could be said to arise.

In *Missouri Pacific*, 192 Ct. Cl. 318, 427 F. 2d 727 (1970), where bonds were exchanged for stock, we adhered to our decision in *Erie Lackawanna* by stating that when bonds are issued in exchange for stock, debt discount is to be measured by the difference between the face value of the new bonds and the amount originally paid for the stock. On reconsideration (193 Ct. Cl. 257, 433 F. 2d 1324 (1970)), we further refined the measurement by deciding that the amount originally paid in for the stock was the floor in computing debt discount but that the stock could have a greater value in the eyes of the corporation. This greater value was to be determined only after consideration of relevant information, including the market value of the stock, the financial conditions of the taxpayer at the time of the exchange, profit prospects, and expert opinion.

Plaintiff has argued that if we adhere to our decision on reconsideration in *Missouri Pacific*, *supra*, and reject the use of fair market value in determining debt discount, we should order a trial to determine the amount actually paid in for the preferred stock. We again reject the fair market value of the preferred stock in this type of transaction as determinative of the value of the shares to the corporation.

However, no trial is needed, because it is established here, as in *Erie Lackawanna*, that there was an exchange of equals, and as in *Erie Lackawanna*, plaintiff in the 1956 exchange got back one $100 par value share of preferred stock for each $100 debenture given up. Accordingly, plaintiff is entitled to no deduction on account of a claimed discount arising out of the 1956 exchange.

We would reach the same result by holding that the value to plaintiff of the preferred stock, received in exchange for the debentures, was significantly greater than what was initially paid in for the stock or its market value as shown

by stock market quotations at the time of the exchange. In *Missouri Pacific* we said that all relevant factors, including the financial condition of the corporation, should be considered. The plaintiff reported to its shareholders that the exchange would increase its after-tax earnings by over $800,000 per year, without considering any saving due to a determination that it incurred debt discount. Considering this factor, we think that a receipt of stock that increased plaintiff's after-tax earnings by more than $800,000 per year cannot be said to be worth less than the face value of the bonds exchanged for the stock.

Plaintiff makes an additional argument with respect to the common stock, which in addition to the debentures, was exchanged for the preferred stock in the 1956 transaction. Plaintiff says that if it is assumed that each share of the preferred stock had a value of $100, plaintiff incurred debt discount in the amount of the value of the common stock given up in the exchange. Thus, plaintiff contends that if each share of common stock was worth $10, the debt discount should be computed by multiplying the total number of shares of common stock by $10.

Wholly apart from our alternate holding on the 1956 transaction, we find that this contention is without merit. In *Missouri Pacific*, we eliminated the value of new stock which, in addition to bonds and notes, was given in exchange for the corporation's outstanding debt securities and stock from consideration in determining debt discount, 192 Ct. Cl. at 321, n. 4, 427 F. 2d at 729, n. 4. In an analogous situation, we ignored the issuance of preferred stock in determining whether there was a carry-over of debt discount and compared only the maturity value of new bonds and cash with the face value of the old bonds given up in the exchange. *Chicago, Milwaukee R.R.* v. *United States*, 186 Ct. Cl. 250, 263, 404 F. 2d 960, 967 (1968).

Common stock is not a fixed debt obligation, and the plaintiff made no definite obligation for the future by issuing those shares.

In addition, it is very difficult to assume that the preferred stockholders who surrendered their preferred shares in 1956 for the debentures believed, or had any reason to believe,

that they were realizing additional interest income through the exchange (because of a debt discount due to the issuance of the common stock). The taxpayer cannot alter or repudiate its bargain to the detriment of the other side of the exchange, at this late date, in order to obtain a tax advantage for itself. *Cf. Bethlehem Steel Corp* v. *United States*, 193 Ct. Cl. 459, 434 F. 2d 1357 (Dec. 11, 1970); *Commissioner* v. *Danielson*, 378 F. 2d 771, 775 (3rd Cir.), *cert. denied*, 389 U.S. 858 (1967).

III

The Reacquisition of Debentures

In 1959, 1960, and 1962,[4] plaintiff reacquired some of the debentures it issued in 1956 for preferred stock. The Internal Revenue Service on audit determined that plaintiff realized a gain on these transactions. The gain was computed on the basis of the maturity value of the debentures less retirement costs and unamortized issuance expense. The plaintiff elected to have these gains excluded from income under section 108(a) and signed Treasury Consent Forms 982 to have the tax basis of its property reduced pursuant to section 1017 by the amount of the gains so excluded from income.[5] In the consent, plaintiff requested that the gain, if

[4] The issues relating to 1962 are based on a carryback loss from 1962 to 1961 and are included in plaintiff's 1961 refund claim.

[5] Sections 108 and 1017 read:

"§ 108. INCOME FROM DISCHARGE OF INDEBTEDNESS

(a) *Special rule of exclusion.*—No amount shall be included in gross income by reason of the discharge, in whole or in part, within the taxable year, of any indebtedness for which the taxpayer is liable, or subject to which the taxpayer holds property, if—

(1) the indebtedness was incurred or assumed—

(A) by a corporation, or

(B) by an individual in connection with property used in his trade or business, and

(2) such taxpayer makes and files a consent to the regulations prescribed under section 1017 (relating to adjustment of basis) then in effect at such time and in such manner as the Secretary or his delegate by regulations prescribes.

In such case, the amount of any income of such taxpayer attributable to any unamortized premium (computed as of the first day of the taxable year in which such discharge occurred) with respect to such indebtedness shall not be included in gross income, and the amount of the deduction attributable to any unamortized discount (computed as of the first day of the taxable year in which such discharge occurred) with respect to such indebtedness shall not be allowed as a deduction."

* * * * * *

Footnote continued on p. 8.

any, reduce the basis of the preferred stock acquired through the issuance of the debentures. The Commissioner of Internal Revenue refused and reduced the basis of plaintiff's property subject to ratable depreciation. The Commissioner did not reduce the basis of plaintiff's property which was subject to the retirement-replacement method of depreciation.

Plaintiff first argues that the issue price of the debentures controls the computation of gain. We agree. The actual issue price, the value of what plaintiff received for the debentures, controls any determination of gain on the cancellation of indebtedness. Treas. Reg. 1.61-12(c); *United States* v. *Kirby Lumber Co.*, 284 U.S. 1 (1931); *Fashion Park, Inc.* 21 T.C. 600 (1954).

However, we have already found that the issue price of the bonds was their maturity value. The value of the stock received by the plaintiff was equivalent to the maturity value of the bonds. Therefore, the Service properly computed the gain on the cancellation of indebtedness.

Plaintiff next argues that these gains should be applied to reduce plaintiff's basis in the preferred stock, the specific property for which the debentures were issued. Treas. Reg. 1.1017-1(a)(1). However, section 1017 clearly requires that the property be held or acquired during the tax year the income is realized. Here the preferred stock was no longer in existence for the years 1959, 1960, and 1962, because it was cancelled or retired immediately after the completion of the 1956 exchange.

Plaintiff's third contention on this issue is that the Commissioner of Internal Revenue erred in failing to reduce the

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Footnote 5—Continued

"§ 1017. DISCHARGE OF INDEBTEDNESS

Where any amount is excluded from gross income under section 108(a) (relating to income from discharge of indebtedness) on account of the discharge of indebtedness the whole or a part of the amount so excluded from gross income shall be applied in reduction of the basis of any property held (whether before or after the time of the discharge) by the taxpayer during any portion of the taxable year in which such discharge occurred. The amount to be so applied (not in excess of the amount so excluded from gross income, reduced by the amount of any deduction disallowed under section 108(a)) and the particular properties to which the reduction shall be allocated, shall be determined under regulations (prescribed by the Secretary or his delegate) in effect at the time of the filing of the consent by the taxpayer referred to in section 108(a). The reduction shall be made as of the first day of the taxable year in which the discharge occurred, except in the case of property not held by the taxpayer on such first day, in which case it shall take effect as of the time the holding of the taxpayer began."

tax basis of all depreciable property owned by it, as required by Reg. 1.1017-1 (b) (7). It is contended that the retirement-replacement method of accounting (which plaintiff uses) is a form of depreciation. Therefore, plaintiff maintains that the Commissioner erred in reducing only the basis of property subject to ratable depreciation.

Defendant counters with two arguments--one attacking the claim on substantive grounds and the other alleging a procedural defect. We do not reach the substantive issue because we find, as defendant contends, that plaintiff did not assert this ground for recovery in its administrative claim for refund and thus cannot now raise it. Section 7422; *United States* v. *Felt & Tarrant Mfg. Co.*, 283 U.S. 269 (1931); *Union Pac. R.R.* v. *United States*, 182 Ct. Cl. 103, 389 F. 2d 437 (1968).

In its claim for refund before the Commissioner of Internal Revenue for 1961 (which is representative), plaintiff sought:

> In each of the aforesaid years taxpayer filed Consent Form 982, electing to exclude the alleged profit set forth above under Section 108(a) and to reduce the basis of property under Section 1017 of the Code. In said Consent, taxpayer stated that it did not concede that the issue price of the debentures was equivalent to the face amount thereof. Taxpayer further requested that the gain, if any, resulting from the acquisition of the Debentures, as finally determined by agreement with the Internal Revenue Service or by a court of competent jurisdiction, should be applied to reduce basis of the specific property acquired; i.e., the Preferred Stock. The Examining Agent refused to reduce the basis of the specific property acquired as requested by taxpayer and, in lieu thereof, applied the general rule and reduced the basis of all of taxpayer's depreciable property to the extent of the amounts of "profit" set forth above. As a result of such reduction in basis, the Examining Agent disallowed deductions for depreciation as follows:
>
> | | |
> |---|---|
> | 1959 | $9,367.70 |
> | 1960 | 9,314.09 |
> | 1961 | 7,949.38 |
> | 1962 | 21,521.89 |
>
> It is the contention of taxpayer that the action of the Examining Agent as explained above was erroneous,

> and that it is entitled to the deductions for depreciation improperly disallowed as aforesaid. * * *

A careful reading of the claim for refund shows that plaintiff asserted that the error of the Internal Revenue Service was its refusal to reduce the basis of the specific property acquired, *i.e.*, the preferred stock, and that the reduction in the basis of "all of plaintiff's depreciable property" to the extent of the profit plaintiff made on the acquisition of the debentures resulted in an improper disallowance of deductions for depreciation. This is the only ground of complaint: there is no suggestion that the Internal Revenue Service erred in reducing the basis of some but not all of plaintiff's depreciable property, or more specifically that the Service erred in not reducing the basis of plaintiff's property subject to the retirement-replacement method of depreciation. In our opinion, the allegations in the claim for refund were insufficient to call the Commissioner's attention to the potential ground for recovery now urged upon us, or to state the facts which would enable the Commissioner to discover for himself and correct what is now claimed to be erroneous action.

It is not determinative of the issue, but the fact that this ground for recovery is not mentioned or referred to in plaintiff's petition is an indication that it was not included in the claim for refund.

The reasons for requiring a ground for refund to be raised first before the Internal Revenue Service were explained in *Union Pac. R.R.* v. *United States, supra:*

> It is an undisputed general rule that a ground for refund neither specifically raised by, nor comprised within the general language of, a timely formal or informal application for refund to the Internal Revenue Service cannot be considered by a court in which a suit for refund is subsequently initiated. * * * The rule that a taxpayer cannot present one ground for refund in its claim and a different ground in its petition is designed both to prevent surprise and to give adequate notice to the Service of the nature of the claim and the specific facts upon which it is predicated, thereby permitting an administrative investigation and determination. * * * In addition, the Commissioner is provided with an opportunity to correct any errors, and if disagreement remains, to limit the scope of any ensuing

litigation to those issues which have been examined and which he is willing to defend. * * * (182 Ct. Cl. at 108, 389 F. 2d at 412) [citations omitted]

Therefore, as a result of the omission in plaintiff's refund claim, the claim cannot now be considered.

IV

Plaintiff's Alternative Contention on the Debt Discount Issue

Plaintiff's final argument is that if it should be denied the right to amortize the debt discount it claims with respect to the 1947 and 1956 transactions, it should nevertheless be permitted to add the claimed debt discount to the cost basis of its depreciable property. The entire argument is predicated on the assumption that plaintiff actually incurred debt discount in the transactions mentioned. Since we have held to the contrary, this claim must also be denied.

V

Conclusion

For the reasons stated above, plaintiff's motion for partial summary judgment is denied. Defendant's motion for partial summary judgment is granted, and to the extent that plaintiff's claims are covered by the foregoing opinion, such claims in plaintiff's petitions are hereby dismissed.

APPENDIX E

In the United States Court of Claims

Nos. 142-67 and 95-68

(Decided June 12, 1970)

MISSOURI PACIFIC RAILROAD COMPANY v. THE UNITED STATES

Robert T. Molloy, attorney of record, for plaintiff. *Mark M. Hennelly*, *Gilbert P. Strelinger*, *Gerald J. O'Rourke*, *Jr.*, and *Robert E. Simpson*, of counsel.

E. Alan Moorhouse, with whom was *Assistant Attorney General Johnnie M. Walters*, for defendant. *Ira M. Langer* (Case No. 142-67) and *Philip R. Miller* and *Theodore D. Peyser* (Case No. 95-68), of counsel.

Before COWEN, *Chief Judge*, LARAMORE, DURFEE, DAVIS, COLLINS, SKELTON, and NICHOLS, *Judges*.

ON PLAINTIFF'S MOTION FOR PARTIAL SUMMARY JUDGMENT AND DEFENDANT'S CROSS-MOTION FOR PARTIAL SUMMARY JUDGMENT

COLLINS, *Judge*, delivered the opinion of the court:

This is a consolidated action[1] by the Missouri Pacific Railroad Company to recover, in addition to certain other

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[1] This action is a consolidation of case No. 142-67 and case No. 95-68. Plaintiff's claim for debt discount deduction is the same in each case except that No. 142-67 is concerned with the taxable years 1957-58, and No. 95-68 relates to the years 1960-61.

claims,[3] the extra taxes which it had to pay as the result of its failure to receive a debt discount deduction for the years 1957–61. Both parties have filed motions for partial summary judgment in regard to the debt discount issue, so that this is the only issue before the court for consideration at this time.

Just recently in the case of *Erie Lackawanna R.R.* v. *United States*, 190 Ct. Cl. ——, 422 F. 2d 425 (Feb. 1970), this court grappled with the question of whether debt discount amortization would arise in instances where a corporation issued bonds in exchange for its own stock. We held that debt discount was not available in such a situation—especially since the face value of the bonds was equivalent to the amount originally paid for the stock. Our decision in *Erie Lackawanna* was limited just to the facts of that case, and we purposely avoided collateral issues such as whether debt discount would be available where bonds were issued for "other types of property," and whether debt discount would arise when the purchase price of the stock was less than the face value of the bonds. As a result of the instant case, we are now required to expand on our ruling in *Erie Lackawanna* and carry it several steps further.

Plaintiff is a corporation organized and existing under the laws of the State of Missouri and has its principal offices located in St. Louis. At all times pertinent to the issues in question, plaintiff was engaged in the business of operating as a common carrier by rail in interstate commerce subject to the jurisdiction of the Interstate Commerce Commission (ICC). For the taxable years in question, plaintiff was an accrual basis taxpayer and filed its federal income tax returns on the basis of the calendar year. Plaintiff, along with its subsidiaries, was reorganized, effective March 1, 1956, pur-

[3] The other claims which are involved in this action, but which will not be considered at this time are: (1) failure to allow a capital loss on the sale of an office building (No. 95–68); (2) improper treatment of corporate distributions as dividends rather than as a return of capital (Nos. 95–63 and 142–67); (3) failure to use the retirement-betterment method of accounting for the installation of welded track (No. 95–68); and (4) failure to allow plaintiff a foreign tax credit for taxes paid to the Republic of Mexico (Nos. 95–63 and 142–67). Also involved in case No. 142–67 was a dispute over how much tax credit plaintiff was entitled to receive in 1958 under § 1341 of the Int. Rev. Code of 1954 for refunds made to the United States of amounts reported as income under claim of right in prior years. This issue was resolved in favor of plaintiff by this court in the case of *Missouri Pac. R.R.* v. *United States*, 191 Ct. Cl. —— (Mar. 1970).

suant to a plan of reorganization approved by the ICC and the Federal district court [3] having jurisdiction over plaintiff's trusteeship under section 77 of the Federal Bankruptcy Act, 11 U.S.C. § 205 (1964). Under the reorganization plan, plaintiff issued: (1) collateral trust notes, (2) first mortgage 4¼% bonds (series B and C), (3) general mortgage income 4¾% bonds (series A and B), (4) 5% 90-year debentures, and (5) stock [4] in exchange for its own outstanding debt securities and stock and the outstanding debt securities and stock of its subsidiaries. As a result of this reorganization, the subsidiaries were merged into and became a part of plaintiff corporation.

The terms of the exchange varied among the holders of the debt and equity interests of plaintiff and its subsidiaries. For instance, in some cases the bondholders received new debt securities (often in various combinations) equal to the face amount of their old debt with the accrued and unpaid interest being paid in cash. Other bondholders received new debt securities in an amount equal to the sum total of the face amount of their old bonds plus the accrued and unpaid interest. The above-mentioned interest had accrued during the years plaintiff was in the process of reorganizing under section 77 of the Federal Bankruptcy Act. This accrued interest was deducted by plaintiff from its gross income for federal income tax purposes during the years in which it became due. In addition, plaintiff also took deductions for certain amounts of amortized bond discount relating to the old bonds. Once the reorganization became effective, all unamortized discount on the old securities was carried forward and amortized during the life of the new securities. [5]

Plaintiff's claim in this case is premised upon the fact that the aggregate maturity value of the new bonds issued pursuant to the reorganization plan was greater than the value

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[3] The plan was approved on March 1, 1956, by the United States District Court for the Eastern District of Missouri by Order No. 4710A.

[4] For purposes of the debt discount issue in this case, the value of the new stock issued as part of the reorganization will not be included in the total amount of property given up by plaintiff. Thus, the stock figures and any reference thereto will be eliminated from consideration for purposes of this decision.

[5] *See, e.g., Chicago, M., St. P. & Pac. R.R.* v. *United States*, 166 Ct. Cl. 250, 404 F. 2d 960 (1968), where this court gave its approval to the idea of carrying forward old discount and amortizing it along with new discount over the life of the new bonds.

of the securities received in exchange, as determined by New York Stock Exchange price quotations. Plaintiff alleges that the aggregate maturity value of the new bonds was $529,117,141, while the fair market value of the old securities given in exchange was determined to be $452,151,252. The difference of $76,965,889 is the amount which plaintiff claims represents the debt discount deduction which must be amortized over the life of the bonds in question. Treas. Reg. § 1.163-3(a)(1), T.D. 6984, 33 Fed. Reg. 19175 (1968); *Helvering* v. *Union Pac. R.R.*, 293 U.S. 282 (1934); *Pierce Oil Corp.* v. *Commissioner*, 32 B.T.A. 403 (1935). Specifically, the instant case is concerned with the taxable years 1957–61. For each of these 5 years, plaintiff asserts that it was entitled to an amortization deduction in the amounts of $1,027,372 in 1957, $1,023,325 in 1958, $1,018,760 in 1959, $1,019,453 in 1960, and $905,650 in 1961. Thus, these are the amounts which form the basis for plaintiff's claim of recovery.[6]

The difference between this case and *Erie Lackawanna* is that, in the latter, debt securities were exchanged for the company's *own stock*. In this case, debt securities of the reorganized and consolidated company were exchanged for the company's *own bonds* and the *stocks and bonds of its subsidiary companies*. Consequently, the question now confronting the court is whether the rule of *Erie Lackawanna* should be extended to cover the types of securities just mentioned, or whether plaintiff's own bonds and the securities of its subsidiaries should be included in a category different from its own stock. Plaintiff urges that the old securities involved in this case should come under the heading of "other types of property," different from a corporation's own stock, and thus should be treated differently. Defendant argues that there is no real difference between a situation where a corporation exchanges debt securities for its own stock and where it exchanges debt securities for the stocks and bonds of its subsidiaries. For reasons to be hereinafter stated we agree basically with the arguments of defendant and render our decision in accordance therewith.

The basis of our decision in *Erie Lackawanna* was that when a corporation exchanged $100 face value bonds for its

[6] The above-mentioned facts have all been agreed to by stipulation of the parties.

own stock for which it had received $100, then it had really lost nothing as a result of the transaction. Plaintiff has tried to argue that we are not concerned with gains or losses (which involve a tax basis problem under sections 1012 and 165 of the Internal Revenue Code of 1954), but rather we are concerned with interest or "compensation for the use or forbearance of money" under section 163. *Deputy* v. *DuPont*, 308 U.S. 488, 498 (1940). We agree that debt discount is normally treated as interest under section 163, but we should point out that in some cases a debt discount deduction has been taken under section 165 which is the loss provision. *E.g.*, *Dodge Bros.* v. *United States*, 118 F. 2d 95 (4th Cir. 1941); *Atlanta & Charlotte Air Line Ry.* v. *Commissioner*, 36 B.T.A. 558 (1937). The distinction, however, is somewhat irrelevant since the amount of the deduction would be the same under either section. Therefore, for purposes of this case, we will accept plaintiff's approach and treat the debt discount as interest, deductible under section 163.

In essence, what this court was saying in *Erie Lackawanna* was that, in the exchange of bonds for stock, there was no difference in the values of what was given up and what was received. In other words, there was an exchange of equals, so that when the transaction was completed the corporation's financial situation had simply been rearranged, but it had not really been changed. The corporation had not obligated itself to pay out any more than it had already received. Consequently, we held in *Erie Lackawanna* that there was no amount which could be treated as interest and deducted as a debt discount. We now find that we are faced with basically the same type of situation as existed in *Erie Lackawanna*.

The main difference between the approach taken by this court in *Erie Lackawanna* (which will be followed today in this case) and that urged by plaintiff in this case is over the method of evaluating the property received for the new bonds. Plaintiff would have us determine the value of the securities received by it in exchange for its new bonds through the use of fair market value as determined by New York Stock Exchange price quotations. Just as we could not accept this method of valuation in *Erie Lackawanna*, where a corporation's own stocks were involved, so also we

cannot accept this method where a corporation's own bonds are involved. Fair market value is meaningless when attached to a piece of property which will no longer be subject to market conditions. It cannot be of any real significance in a situation such as this where plaintiff's old securities were immediately destroyed upon redemption. Instead, the face value of plaintiff's old bonds at the time of their issuance is the true valuation of these securities *as far as plaintiff is concerned. See Union Pac. R.R.* v. *United States*, 185 Ct. Cl. 393, 401 F. 2d 778 (1968), *cert. denied*, 395 U.S. 944 (1969). The fact that the fair market value of the old bonds may be less than the face value of the new bonds can in no way reduce the amount of value originally paid to plaintiff for the old securities. Consequently, for the court to say that plaintiff is entitled to a debt discount deduction because the fair market value of the old bonds is less than the maturity value of the new bonds is to give credence to an illusional or fictional interest charge which does not actually exist. For this reason, we cannot adopt plaintiff's method of valuation.

In addition, if we were to employ plaintiff's system of determining debt discount through the use of fair market value, it would appear that plaintiff would be unjustly increasing the amount of its deductions without correspondingly increasing its obligations. We have already conceded that plaintiff is entitled to carry over the discount from the old bonds. To then say that plaintiff is entitled to further discount as the result of the old bonds having a fair market value less than the face value of the new bonds would result in allowing plaintiff to increase the amount of its discount simply by substituting new obligations for old. We do not feel that a corporation should be allowed to increase the amount of its allowable deductions in such a manner, unless there truly is an increase in its bond indebtedness. Plaintiff has not been able to show that there is such an increase in this case.

We stated in *Erie Lackawanna* that, in the bond discount area, a corporation's own stock (and we have expanded this to include a corporation's own bonds by this case) comprises a category completely separate from cash and other types of property. The reason for this categorization should now be obvious. If plaintiff exchanged its bonds for some tangible

property such as the inventory of a corporation or even for the securities of another corporation, it would be understandable to value this property, for purposes of determining debt discount, through the use of fair market value.[7] However, there is a great deal of difference between this situation and one where a corporation receives its own stocks and bonds. Fair market value in the latter instance just does not have the same significance nor does it create the same result as in the former.

Having rejected plaintiff's method of computing debt discount through the use of fair market value and having placed a corporation's own bonds in the same category as its own stock, it now becomes necessary to determine how the stocks and bonds of a corporation's subsidiary should be categorized. Plaintiff would have us follow the reasoning of the United States Court of Appeals for the Third Circuit in *American Smelting & Ref. Co.* v. *United States*, 130 F. 2d 883 (3d Cir. 1942). In that case, the court ruled first that debt discount amortization would be available where stock of a subsidiary corporation was used as payment for the issuance of new

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[7] We do not mean to imply by this statement that we are now holding that debt discount is available where bonds are issued for property (other than the corporation's own securities). In fact, there appears to be a definite split of authority on this question with *Nassau Lens Co.* v. *Commissioner*, 308 F. 2d 39 (2d Cir. 1962), and *American Smelting & Ref. Co.* v. *United States*, 130 F. 2d 883 (3d Cir. 1942), holding that debt discount is available where bonds are issued for property, and *Southern Natural Gas Co.* v. *United States*, 188 Ct. Cl. 302, 413 F. 2d 1222 (1969), *Montana Power Co.* v. *United States*, 141 Ct. Cl. 620, 160 F. Supp. 892, *cert. denied*, 358 U.S. 842 (1958), and *Montana Power Co.* v. *United States*, 222 F. 2d 541 (3d Cir.), *cert. denied*, 382 U.S. 943 (1956) (dictum), stating that debt discount is not so available. We are simply saying that, as between the situation where a corporation issues bonds for its own securities and where a corporation issues bonds for other types of property, we can better understand how fair market value could be applied to the latter situation but not to the former—assuming, for the moment, that debt discount would be available in the latter situation.

It should be pointed out that this problem may not arise in the future because of the Tax Reform Act of 1969, 83 Stat. 487. Both the House and Senate Reports have indicated that there may be original issue discount when a corporation issues a bond for a price less than its face value whether it receives cash, stock, *or other property* (including the assets of another corporation). Also, in a case where a bond is issued for property, it is provided that the issue price of the bond will be the fair market value of the property. S. Rep. No. 91-552, 91st Cong., 1st Sess. 148 (1969); H.R. Rep. No. 91-413 (Part I), 91st Cong., 1st Sess. 110 (1969).

We do not feel that such a provision would be detrimental to our decision in this case, especially in light of a Senate amendment which now provides that the issue price of bonds issued in reorganizations shall be the stated redemption price at maturity, Tax Reform Act of 1969, 26 U.S.C.A. § 1232(b) (1970).

debt securities by the parent. In addition, the court held that the cost of the debt securities should be determined by reference to the fair market value of the stock at the time of the exchange. Thus, once again, plaintiff would have us regard the securities of a subsidiary as property which should be treated differently from a corporation's own stock, and it also urges us once more to use fair market value as the means of determining valuation. However, we are unable to accept these arguments by plaintiff just as we are unable to accept the decision of the Third Circuit in *American Smelting & Ref. Co.* v. *United States*, *supra*.[8]

In the situation which exists in this case, where, prior to the reorganization, the subsidiaries involved were wholly owned,[9] there is no real difference between an exchange by a corporation of bonds for its own securities and those of its subsidiaries. The same general rule applies, namely, that the true value of the stocks and bonds *in the eyes of the corporation* is the original value of the securities, which value becomes a part of the assets of the parent corporation as the result of the reorganization and merger. Once again, to try and say that the cost of the new bonds is the fair market value of the old securities, at the time of the exchange, would be to create an interest charge that does not exist since the effect on the capital structure of the corporation would be the same regardless of the fair market value of the old securities. Consequently, we conclude that the securities of the subsidiaries involved in this case[10] should be treated the same as the securities of plaintiff corporation.

One point which we purposely failed to consider in *Erie Lackawanna* was whether debt discount would arise in a

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[8] This court has on two occasions specifically rejected the decision in *American Smelting & Ref. Co.* v. *United States*, *supra*—once in *Southern Natural Gas Co.* v. *United States*, *supra*, and again in *Montana Power Co.* v. *United States*, 141 Ct. Cl. 620, 159 F. Supp. 593, *cert. denied*, 358 U.S. 842 (1958).

[9] The two main subsidiaries involved in this case were New Orleans, Texas & Mexico Railway Company and International-Great Northern Railroad Company. Plaintiff owned approximately 94% of the common stock and all the preferred stock of New Orleans. (The remaining 6% was publicly owned.) New Orleans owned all the stock of International.

[10] The securities of the subsidiaries which are involved in this case are: New Orleans first mortgage bonds (series A–D), New Orleans common stock, International first mortgage bonds (series A–C), and International adjustment mortgage 6% bonds.

situation where the amount paid for the stock was less than the maturity value of the bonds. The corresponding issue in this case is whether debt discount will arise if the value of the old bonds is less than the value of the new bonds.

In examining the majority of the exchanges which took place as a part of the reorganization, it would appear that it would again be unnecessary to determine the answer to the above-stated issue. This is because in most of the transactions there was an exchange of items of equal value. For instance, in the exchange of new first mortgage 4¼% bonds (series B and C) for old Missouri Pacific first and refunding mortgage 5% bonds, and in the exchange of new collateral trust notes for old New Orleans, Texas & Mexico Railway Company first mortgage bonds (series A–D), there was an exchange of equal values of old and new bonds—with the accrued interest being paid separately in cash. In the rest of the transactions (except for two), there was an exchange of new bonds for old bonds to the extent that the value of the new bonds equaled the value of the old bonds plus accrued interest. Thus, again there was an exchange of equals, except this time plaintiff received an old bond plus a cancellation of interest indebtedness which together equaled the value of the new bond. In both types of transactions, plaintiff was receiving the equivalent of what it was giving up, so that there was nothing which could be deducted as interest.

However, based on the figures presented in the record, there appear to be two instances in which the exchange of bonds for securities was not equal. This occurred in the exchange of new first mortgage 4¼% bonds (series C) and general mortgage 4¾% income bonds (series A and B) for the publicly held common stock of New Orleans, Texas & Mexico Railway Company. The other instance involved the exchange of new first mortgage 4¼% bonds (series B and C) for old Little Rock & Hot Springs Western Railroad Company first mortgage 4% bonds. Assuming that the figures which we now have are correct, which indicate that there is a difference between the value of the new bonds and the amount received in exchange therefor, it becomes necessary to decide whether this difference should give rise to a

discount in light of the fact that this exchange was part of a corporate reorganization.

There is some authority to the effect that where there is a difference between the maturity value of the bonds and the amount received in exchange, and this takes place during a reorganization, then this difference should not be treated as debt discount. *Montana Power Co.* v. *United States*, 232 F. 2d 541, 549–50 (3d Cir.), *cert. denied*, 352 U.S. 843 (1956) (dictum); *New York, C. & St. L. R.R.* v. *Commissioner*, 23 B.T.A. 177 (1931); Rev. Rul. 59–387, 1959–2 Cum. Bull. 56. In the revenue ruling, the Commissioner of Internal Revenue held that where there was an issuance of 30-year debentures by a corporation for its own preferred stock, this was simply a recapitalization, and the preferred stock could not be recognized as assets in the hands of the corporation. Thus, considering the character of the exchange, the Commissioner did not feel that there was bond discount in the true meaning of the term. In *Montana Power Co.* v. *United States*, *supra*, three of the seven judges, in a dicta portion of the opinion, stated that an underlying theory of bond discount is that the transaction must be negotiated in the open market and at arm's length. They did not feel that such elements were present in a tax-free corporate reorganization.

Despite this authority, which is not exactly overwhelming in its strength or particularly persuasive in its approach, we find that bond discount can arise where there is a difference between what is given up and what is received, and this can occur in connection with a corporate reorganization. The fact that there is a difference in value between the bonds being issued and the securities being given up is enough to invoke the debt discount provision. The ultimate result of this difference is that the corporation is obligating itself to pay a debt which is greater in value than that which it is receiving. It seems irrelevant that what the corporation is receiving is its own securities, or that they will be destroyed because, in essence, these securities still have a value with the corporation, namely, their original cost. This original cost is still a part of the corporate assets and thus should be considered as the

actual amount paid for the issuance of the new bonds. Consequently, any difference between this amount and the maturity value of the bonds should be treated as a discount and amortized over the life of the bonds.

To summarize the conclusions of the court in this case, we hold:

(1) That for purposes of determining debt discount, the debt securities and stock of a corporation and the debt securities and stock of a corporation's wholly owned subsidiary, which are given up for a corporation's new bonds, should be treated alike.

(2) That when exchanged for new bonds, the above-mentioned securities should not be evaluated by the use of fair market value. Instead, the stocks should be given a value equal to the amount originally paid for them, and the value of the bonds should be determined by their maturity value as of the time of issue.

(3) That debt discount is available where the value of the stocks or bonds, as determined in item (2) above, is less than the maturity value of the debt securities for which they are exchanged.

Applying these rules, we find that, in the present case, there was no debt discount available in any of the exchanges which were a part of the reorganization—except possibly in two of the transactions. In regard to these two transactions, which involve the publicly held common stock of New Orleans, Texas & Mexico Railway Company and the bonds of Little Rock & Hot Springs Western Railroad Company, we do not have sufficient information to make a final decision. The record indicates neither the amount originally paid for the common stock,[11] nor the exact figures of the Little Rock transfer—especially the amount of accrued interest involved, if

[11] In a letter to Mr. Roswell Magill from Mr. H. T. Swarts, Director, Tax Rulings Division, dated March 13, 1956, New Orleans, Texas & Mexico Railway Company was listed as having 148,329 shares of outstanding common stock at $100 par value. The schedule referred to in finding 8 of *Missouri Pac. R.R. v. United States*, 167 Ct. Cl. 725, 736, 337 F. 2d 637 (1964), lists the principal amount of this publicly held common stock to be $859,800. We are not certain whether either figure has any relation to the amount actually paid for the stock.

any.[13] As a result, we are remanding the case to the trial commissioner in order that he might compel the production of the data necessary to reach a final determination in regard to these two transactions. If the commissioner should find that there is a difference in value between the new Missouri Pacific bonds and the old securities given in exchange therefor, plaintiff will be entitled to a debt discount deduction in an amount which will be determined by the commissioner. If no such difference is discovered, then plaintiff will not be entitled to any discount deduction. In either case, unless the parties hereto stipulate in the interest of time, the commissioner shall report his findings to the court for final determination and judgment.

[13] There is quite a discrepancy between the figures in plaintiff's schedule A, attached to the order of the district court, and the schedule in *Missouri Pac. R.R.* v. *United States*, *supra*, relating to the exchange of Little Rock & Hot Springs Western Railroad Company first mortgage 4% bonds for Missouri Pacific Railroad Company first mortgage 4½% bonds (series B and C). In plaintiff's schedule A, $1,519,346 worth of new bonds were exchanged for $1,140,000 worth of old bonds (as listed in the March 13th letter to Mr. Magill, note 11 *supra*). However, in the schedule in the *Missouri Pacific* case, $1,344,582 worth of new bonds were exchanged for a similar amount of Little Rock bonds. Because of this discrepancy, we feel the transaction should be examined by the commissioner.

In the United States Court of Claims

Nos. 142-67 and 95-68

(Decided November 13, 1970)

MISSOURI PACIFIC RAILROAD COMPANY v. THE UNITED STATES

Robert T. Molloy, attorney of record, for plaintiff.

E. Alan Moorhouse, with whom was *Assistant Attorney General Johnnie M. Walters*, for defendant. *Philip R. Miller* and *Theodore D. Peyser*, of counsel.

Before COWEN, *Chief Judge*, LARAMORE, DURFEE, DAVIS, COLLINS, SKELTON, and NICHOLS, *Judges*.

ON DEFENDANT'S MOTION FOR REHEARING OR RECONSIDERATION

PER CURIAM: Defendant has asked us to reconsider part of our holding in this case. 192 Ct. Cl. ——, 427 F. 2d 727 (June 12, 1970).[1] The objection is to the conclusion, in our original opinion, that, when new bonds are issued for old stocks, debt discount is available where the amount originally paid for the old stocks is less than the maturity value of the new debt securities for which they are exchanged. We applied that rule to the publicly held common stock of New Orleans, Texas & Mexico Railway Company, and remanded the case to the trial commissioner to determine the amount originally paid by the taxpayer-plaintiff for that stock. The Government urges that this rule is not appropriate for an exchange of new bonds for old stock.

[1] Plaintiff has also filed a motion for reconsideration which is being denied today, by order without opinion.

Since our original opinion, a helpful decision has been rendered on this very point in the Southern District of New York. *Cities Service Co.* v. *United States*, 26 AFTR2d ¶ 70-5100, p. 70-5378 (July 24, 1970). Judge Mansfield there points out (26 AFTR2d at 70-5385) that the basic principle for the allowance of debt discount is that a "true loss", i.e., a detriment, must be sustained by a taxpayer issuing obligations payable at their face value at some future date, and that, if in fact the taxpayer receives a lesser consideration upon issuance than it will have to return at maturity, the difference is normally considered a debt discount in the absence of circumstances indicating otherwise. That is the general principle we followed in *Erie Lackawanna R.R.* v. *United States*, 190 Ct. Cl. 682, 422 F. 2d 425 (1970), and endeavored to apply in our opinion in the present case.

With respect to the particular problem of debt obligations exchanged for stock, the *Cities Service* opinion holds (26 AFTR2d at 70-5387) that the *minimum* amount the taxpayer may ascribe to the shares acquired by it for the new debt obligation is the original consideration, and "even if the market value of the shares at the time of the exchange had declined below their original issue price [taxpayer], would be precluded from claiming the decline in value as a loss because, having received the cost price upon issuance of the shares, it had not actually suffered a loss to the extent of the market decline." With this statement, we agree, of course.

The District Court then goes on to hold (26 AFTR2d at 70-5387), contrary to our original opinion in this case, that the original issue or cost price of the exchanged shares did not represent the ceiling value of the stock for the purpose of calculating debt discount. Its reasoning is that at the time of the exchange the shares could have a greater value to the taxpayer than the original issue or cost price. "Thus, where a taxpayer receives its own shares in exchange for issuance of its debentures, the value of 'what is received' for the purposes of determining the deductible loss or discount may be higher (though not lower) than the original issue price of the shares. The actual value to the taxpayer can be determined only after consideration of all relevant data, including the

market value of the shares, the financial condition of the taxpayer at the time of the exchange, its profits prospects, and expert opinion."[3]

On reconsideration, persuaded by this *Cities Service* discussion, we hold that, with respect to shares of its own stock or stock in its subsidiaries, the present taxpayer cannot calculate, for debt discount purposes, the value of the stock at its cost or issuance price. That figure can be the floor but it cannot be the ceiling. The correct measure is the value of the New Orleans stock to plaintiff at the time of the exchange of the bonds for that stock.

In this instance, however, we need not order a trial to determine that value.[4] That determination has already been made. In taxpayer's reorganization proceedings, the value of the New Orleans stock was extensively canvassed before the Interstate Commerce Commission and the courts. See *Missouri Pac. R.R. Reorganization*, 275 I.C.C. 59, 113, 125–27 (1949); 290 I.C.C. 674, 678–79 (1954); *In re Missouri Pacific R.R.*, 93 F. Supp. 832, 848–49 (E.D. Mo., 1950), 129 F. Supp. 392, 399 (E.D. Mo. 1955); *State of Texas* v. *Group of Institutional Investors*, 191 F. 2d 265, 273–74 (8th Cir. 1951) *cert. denied*, 342 U.S. 904 (1952); *Missouri Pacific R.R. 5¼% S.S.B.C.* v. *Thompson*, 229 F. 2d 898, 900–01 (8th Cir. 1956). The final reorganization plan, which was confirmed and adopted, found the stock to be then worth $250 per share, but only $216 in maturity value of the bonds was allocated to each share, as the "equitable equivalent" of the $250 value. *Missouri Pac. R.R. Reorganization*, *supra*, 290 I.C.C. at 678–79. Thus, the value of the New Orleans stock, at the time of the exchange, has authoritatively been found, after considerable and careful inquiry (including expert testimony), to be not less than the maturity value of the bonds exchanged. *Cf. Arkansas-Missouri Power Corp.* v. *Paschal*, 243 F. 2d 584, 588 (8th Cir), *cert denied*, 355 U.S. 835 (1957).

The fact that the stock was selling for less on the stock exchange is not at all conclusive (*Cities Service Co.* v. *United States*, *supra*, 26 AFTR2d at 70–5387), and in this case is

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[3] The opinion emphasizes that the market price would be relevant but not conclusive, and that the significant figure is that "representing the value to plaintiff [the taxpayer] of the shares in question."

[4] In *Cities Service*, a trial was directed.

clearly outweighed by the other factors which led the Interstate Commerce Commission and the federal court to find and determine that the new bonds were a "fair and equitable" equivalent for the New Orleans stock. There was, therefore, no debt discount on the issuance of the bonds since the plaintiff-taxpayer received at least the equivalent (in stock value) of the maturity value of the bonds.

This conclusion calls for a modification of our prior holding and opinion. The exchange involving the New Orleans stock falls into the same category as the majority of the transactions dealt with in that opinion—there was no debt discount on the transaction—and there is no need for a remand. The remand ordered in our prior opinion is, accordingly, restricted to the transaction involving the Little Rock bonds. In addition, the last portion of our prior opinion, 192 Ct. Cl. ——, ——, 427 F. 2d at 739–34,[4] is modified to refer only to bonds and other debt obligations, not to stock, insofar as the holding is that the original value of the securities must be looked to for the purpose of determining whether a bond discount exists. The few references in that opinion to the original cost of shares of stock as determinative are stricken and replaced by the standard of the actual value of the stock to the taxpayer at the time of the exchange. It goes without saying that, with respect to bonds exchanged for bonds, the opinion still stands as written.

To the extent indicated in this opinion the defendant's motion for rehearing or reconsideration is granted and our prior decision and opinion are modified.

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[4] Beginning with the sentence (slip op., p. 8), "The same general rule applies, namely, that the true value of the stocks and bonds in the eyes of the corporation is the original value of the securities, which value becomes a part of the assets of the parent corporation as the result of the reorganization and merger," and continuing through to the end of the opinion.

U.S. GOVERNMENT PRINTING OFFICE: 1970

APPENDIX F

* * *

[¶ 9305] Gulf, Mobile and Ohio Railroad Company, Plaintiff v. United States of America, Defendant. Gulf, Mobile and Ohio Railroad Company, Plaintiff v. United States of America, Defendant.

U. S. District Court, So. Dist. Ala., So. Div., Civil Action Nos. 5662-69, 6332-70, 2/18/72.—(339 F. Supp. 489.)

[Code Secs. 61 and 163]

Deduction: Bond issue discount expense: Interest: Bonds exchanged for preferred stock: Bond discount determined.—The corporate taxpayer was entitled to amortize bond discount over the life of the bonds that arose on the exchange of bonds for the corporation's outstanding preferred stock. However, the amortization deduction could not be based on the amount of discount that was determined by subtracting the total market value of the preferred stock, as determined by the listed price on the New York Stock Exchange, from the principal amount of the bonds issued. Rather, the discount on which the amortization had to be based was (1) the difference between the issue price originally received by the taxpayer for the preferred stock and the par value of the bonds, or (2) the difference between the fair market value of the preferred stock and the par value of the bonds if the taxpayer was able to show that the fair market value of the stock at the time of the exchange was greater than the issue price. The court ruled, however, that no bond discount would exist if either the issue price of, or the fair market value of, the preferred stock exceeded the par value of the bonds. Back references: ¶ 674.1326 and 1416.05.

J. N. Ogden, W. H. Sanders, P. O. Box 1828, Mobile, Ala., W. A. Kimbrough, P. O. Box 5583, Mobile, Ala., for plaintiff. C. S. White-Spunner, Jr., P. O. Drawer E, Mobile, Ala., Donald B. Craven, Department of Justice, Washington, D. C. 20530, for defendants.

Order

PITTMAN, District Judge: This case is now submitted upon defendant's Motion For Partial Summary Judgment and plaintiff's Cross Motion For Partial Summary Judgment.

This court has jurisdiction in this matter pursuant to Section 1346(a)(1) of Title 28 of the United States Code.

On November 8, 1957, and supplemented on November 19, 1957, the plaintiff, Gulf, Mobile and Ohio Railroad Company (here-

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inafter referred to as "taxpayer") applied to the Interstate Commerce Commission (ICC) for authority to issue five-percent income debentures, Series A, due December 1, 2056, in principal amount not to exceed $28,343,800. The income debentures were to be exchanged on a voluntary basis for up to 283,438¼ shares of taxpayer's issued and outstanding preferred stock, without par value, $5 Series, with a stated value of $100 per share. The terms of the exchange were one Series A income debenture in principal amount of $100 for one share of preferred stock.

The interest on the income debenture was payable currently, only if earned, and cumulative interest was limited to 15 percent. The preferred stock was without par value and carried a stated value of $100. Dividends on the preferred were payable at the rate of $5 per share per annum when and as declared by the board of directors and were cumulative, subject, however, to certain limitations. The stock was callable at its stated value plus any accumulated and accrued dividends. It was carried on taxpayer's balance sheet at its stated value of $100 per share. At all times here relevant, the preferred stock and income debentures were listed and traded on the New York Stock Exchange. At the date of the exchange the market price for the preferred shares was less than the principal amount of the debentures.

On December 20, 1956, the Interstate Commerce Commission granted plaintiff the authority to issue the income debentures. Pursuant to that order, taxpayer, during the period December 31, 1957, through December 31, 1962, issued a total of 187,116 income debentures in exchange for a like number of shares of preferred stock.[1] The total exchange resulted in a debit of $18,711,600 to the preferred stock account and a corresponding credit to the income debentures account in the same amount.

[Amount of Discount]

Subsequently, taxpayer filed claims for refund with respect to its taxable years ended December 31, 1959 and 1961, in which it claimed a refund of taxes based on, among other things, a deduction for amortizable bond discount arising from the exchange of the above debentures. The deduction was computed by taking the total principal amount ($18,711,600) of debentures issued and subtracting therefrom the total market value ($11,869,092.44) of the preferred stock, as determined by the listed price on the New York Stock Exchange. The result, $6,842,507.56 was determined by taxpayer to be the total discount arising from the exchange, which amount was claimed to be amortizable over the life of the debentures. Upon disallowance of these claims, these actions were timely commenced.

The crux of the problem in these cases dealing with bond discount is that there is no statutory treatment of the subject. Section 163 of the Internal Revenue Code of 1954 allows corporations and individuals to deduct all interest paid or accrued within the taxable year. This has been supplemented by Internal Revenue Regulation 1.163-3(a) which provides:

> "If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. For purposes of this section, the amortizable bond discount equals the excess of the amount payable at maturity (or, in the case of a callable bond, at the earlier call date) over the issue price of the bond."

It is agreed by the parties that if the bonds had been issued for cash in the amount of the selling price of the preferred stock at the time of the exchange, the discount would be proper and the amortization deduction allowed. Taxpayer contends that the bonds-for-stock situation presented here should be treated the same as bonds-for-cash. The argument is that there is no basis in economic reality for differentiating between the two transactions. Also, it is pointed out that the same result could have been accomplished in a two-step exchange (bonds for cash; cash for preferred stock) which arguably would have escaped the challenge encountered here. The Government maintains that the bonds-for-stock exchange is an entirely different event than one involving cash and should meet with a different result. The transaction is characterized as a recapitalization within the meaning of Section 368(a)(1)(E) of the Internal

[1] The amounts of the exchanges were:
1957—$95,200 in principal amount of income debentures for 852 shares.
1958—$12,653,000 in principal amount of income debentures for 126,530 shares.
1959—$337,800 in principal amount of income debentures for 3,378 shares.
1960—$1,046,300 in principal amount of income debentures for 10,463 shares.
1961—$3,767,300 in principal amount of income debentures for 3,673 shares.
1962—$822,000 in principal amount of income debentures for 8,220 shares.

Revenue Code of 1954 with the result being a mere reshuffling of the capital structure with no new capital added. The fact that taxpayer's preferred stock account was debited $100 for each share of stock taken in, and the income debenture account credited $100 for each bond that was issued, is cited as proof of the "reshuffling" aspect of the exchange.

In deciding this issue, the court is faced with an apparent conflict of authority. Taxpayer relies upon decisions from the Second, Third, and Tenth Circuits as well as several District Court cases. *Atchison, Topeka & Santa Fe Railroad Co. v. United States*, 71-1 USTC ¶ 9430 (10th Cir. 1971); *Nassau Lens Co. v. Commissioner* [62-2 USTC ¶ 9723], 308 F. 2d 39 (2nd Cir. 1962); *Montana Power Co. v. United States* [56-1 USTC ¶ 9402], 232 F. 2d 541 (3rd Cir. 1956); *American Smelting & Ref. Co. v. United States* [42-2 USTC ¶ 9670], 130 F. 2d 883 (3rd Cir. 1942); *Claussen's Inc. v. United States*, 71-2 USTC ¶ 9632 (S. D. Ga. July 29, 1971); *Cities Service Co. v. United States* [70-2 USTC ¶ 9537], 316 F. Supp. 61 (S. D. N. Y. 1970), reaff'd 71-2 USTC ¶ 9501 (1971); *Industrial Dev. Corp. v. United States* [56-2 USTC ¶ 10,066], 51 A. F. T. R. 1514 (N. D. Ill. 1956); *Southern Fertilizer & Chem. Co. v. Edwards* [55-1 USTC ¶ 49,133], 167 F. Supp. 879 (M. D. Ga. 1955).

The Government places its emphasis on a line of Court of Claims decisions and a recent Tax Court case. *St. Louis-San Francisco Ry. Co. v. United States* [71-2 USTC ¶ 9544], 28 A. F. T. R. 2d 5243 (Ct. Cl. July 14, 1971); *Missouri Pacific Ry. Co. v. United States* [70-2 USTC ¶ 9698], 433 F. 2d 1324 (Ct. Cl. 1970); *Erie Lackawanna Ry. Co. v. United States* [70-1 USTC ¶ 9245], 422 F. 2d 425 (Ct. Cl. 1970); *Southern Natural Gas Co. v. United States* [69-2 USTC ¶ 9473], 412 F. 2d 1222 (Ct. Cl. 1969); *Montana Power Co. v. United States* [58-1 USTC ¶ 9332], 159 F. Supp. 593 (Ct. Cl. 1958), cert. denied 358 U. S. 842 (1958); *National Alfalfa Dehydrating and Milling Co. v. Commissioner* [CCH Dec. 31,030], 57 T. C. 46, 40 L. W. 2247 (Tax Ct. Oct. 14, 1971). A discussion of all the cases in chronological order is thought to be helpful in determining the progression of thinking in the area.

[*Bonds-for-Stock Cases*]

American Smelting & Ref. Co. v. United States, supra, was the first definitive holding that an amortization deduction may arise in a case where bonds are issued for property. The Third Circuit allowed as additional interest deductions bond discount measured by the difference between the maturity value of the bonds and the market value of the preferred stock which had been received. The facts of the exchange were similar to these[3] except that the taxpayer received not its own shares in return for the bonds, but those of a wholly owned subsidiary. The court refused to make the dividing line for bond discount whether the bonds were exchanged for cash or whether they were exchanged for something else. While recognizing "the possibilities of great difficulty in determining with sufficient exactness the difference between the par value of the bonds and the thing other than cash received for the bonds by the obligor," 130 F. 2d at 886, the majority determined that in the case before them, the cost of the bonds was the fair market value of the stock at the time the corporate obligations were exchanged. Taxpayer's proof of the fair market value consisted of the selling price of the preferred stock on the New York Stock Exchange at the time of the exchange and immediately thereafter. Thus, market price was deemed to be sufficient to establish the value of the stock. The dissenting judge disagreed on this point while implicitly concurring with the proposition that bonds-for-stock exchanges could give rise to bond discount if the proof of value was sufficient.

Although *American Smelting* was not cited, the same result was reached in *Southern Fertilizer & Chem. Co. v. Edwards, supra*, one of the two decisions on the issue by District Courts within the Fifth Circuit.[4] Amortization of bond discount was allowed upon a finding that "the evidence amply supports plaintiff's contention that its debenture bonds were issued for a consideration of not more than $75 per $100 face amount of bonds." 167 F. Supp. at 881. However, the issue of proof, regarded as so important in *American Smelting* was not considered because the bonds were stipulated to be worth only 75% of face amount

[3] Taxpayer sought to amortize discount which it claimed had been incurred upon the exchange in 1917 of its 30-year, $100, 5% bonds for 5% and 6% preferred stock of a wholly owned subsidiary corporation with a par value of $100 per share.

[4] Taxpayer issued cash, noncumulative, preferred stock, scrip and its own debenture bond for each share of its 8% cumulative preferred stock in accordance with a negotiated plan of recapitalization. The debenture bonds issued had a par value of $100 and a market value of $75 per share.

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The situation where debentures are issued in exchange for the taxpayer's own stock was also considered in *Industrial Dev. Corp. v. United States, supra.*[4] The District Court for the Northern District of Illinois held that the taxpayer's right to bond discount was unaffected by what was received in return. Discount was based on the difference between the face value of the debentures and the market value of the preferred stock. The court ruled that the fact that the debentures were issued in connection with a tax-free recapitalization did not negate bond discount. Once again, *American Smelting* was not cited and the findings of fact and conclusions of law were made with little discussion.

[Bonds for Property]

The Third Circuit, in *Montana Power Co. v. United States, supra,* reaffirmed its ruling in *American Smelting* on its facts. No bond discount was allowed in a bonds-for-property transaction[5] on the basis that the taxpayer had failed to introduce any evidence of the fair market value of the property received. This appears to be consistent with the *American Smelting* holding that the taxpayer bears the burden of establishing the fair market value of that for which the bonds were issued. However, in dicta, the court refused to follow *American Smelting* in the situation of a bonds-for-property exchange. In discussing *American Smelting,* the court stated:

"It is true in commenting on the government's contention [in the *American Smelting* case] we stated that 'we do not think . . . that the question whether amortization is permitted is settled by making the dividing line between transactions in which bonds are issued for cash and transaction where bonds are issued for something else' but that comment must be considered in the light of the specific question presented for determination. The 'something else' in that case was 'preferred stock' of a wholly-owned subsidiary which the taxpayer received in a recasting of its corporate structure—the issuance of bonds for preferred stock there was in substance a 'funding operation' in which the taxpayer substituted for its preferred stock liability its bond liability. There was not in that case the issuance of bonds and attending creation of a liability in a purchase transaction for investment purposes as was true in this case. The *American Smelting* decision in that respect must be limited to its facts." 232 F. 2d at 546.

Thus, the court appears to have accepted the bonds-for-stock rationale of *American Smelting,* but refused to extend it to an exchange in which property is received.

The Court of Claims also had occasion to consider a claim for bond discount in a bonds-for-property exchange in *Montana Power Co. v. United States, supra.* In that case, the taxpayer issued 30-year debentures for which it received property valued at less than the face amount of the debentures. The corporation retired the debentures at face amount before the thirty-year period and attempted to calculate bond discount as the difference between the principal amount of the debentures and the basis of the assets it had received in exchange. The court sustained the disallowance of the deduction, holding that, as long as the property received for the securities is held, no "loss" can properly be considered as having occurred. Thus, no tax consequences can arise until the gain or loss is realized by a sale of the property. Unanswered was the question of what the tax consequences would be at the time of the sale of the property. The Court of Claims, like the Third Circuit itself, refused to give credence to *American Smelting* in the area of bonds-for-property exchange. The court did not consider a bonds-for-stock exchange and did not address itself to the issue of whether a retirement of the taxpayer's stock upon its receipt would constitute a "realization" for tax purposes.

The time element of realization was also an important factor when the Second Circuit considered bond discount in a bonds-for-property transaction in *Nassau Lens v. Commissioner, supra.*[6] The court, faced with the contention that bond discount is never

[4] The exchange of $140 of debentures plus $10 cash for each share of preferred stock was made pursuant to a plan of statutory merger of taxpayer and a subsidiary corporation. The preferred stock had a par value of $100 per share and a fair market value of $106 per share, at the time of the exchange. The stock carried cumulative dividends at the rate of, but not required to be, $7 per share per annum, payable when declared.

[5] Taxpayer issued 30-year, 5% debentures with an aggregate principal amount of $10,589,900 in a tax-free reorganization for certain natural gas properties. The difference between the tax cost basis of the assets and the principal amount of the debentures was claimed as a bond discount. Both parties to the exchange were almost completely owned by a common third party.

[6] Taxpayer transferred 100, 10-year debentures, each with an issuance value of $1,000 and with a principal amount of $1,500. The notes were non-interest bearing and were redeemable prior to maturity at taxpayer's election in accordance with a schedule of payments. Taxpayer also assumed $60,752,740 of liabilities and received in exchange assets valued at $160,752,74.

available when the obligations are issued for property, thought it important that since the debentures could be redeemed at various times for various amounts, the cost of the property could not be determined until the redemption. This might not occur until long after the property had been resold. The court concluded that bond discount is the cost of using the money which is needed to purchase the property and found no support for the contention that the seller who also becomes a financing medium by accepting bonds should be treated differently than one who takes cash. *American Smelting* was cited with approval while it was recognized that the value of property is more uncertain than the value of cash.

The Court of Claims followed its *Montana Power* decision with very little discussion in *Southern Natural Gas Co. v. United States, supra*.[1] The holding that there can be no tax consequences as long as the property received for the securities is retained was again reiterated. The only factual difference in the cases was that *Montana Power* had involved a tax-free reorganization whereas the transaction in *Southern* was a taxable one. The court held that "the *Montana Power* rule was clearly meant to apply to the issuance of bonds for property in either situation." 412 F. 2d at 1238. Also, quoting the exact language of *Montana Power*, the court expressly refused to follow *American Smelting* to the extent that the cases were inconsistent.

[Determination of Discount]

Another factor of value determination, the amount originally received for the preferred stock by the taxpayer, was interjected into bond discount determination by the Court of Claims in *Erie Lackawanna Ry. Co. v. United States, supra*. On facts similar to the present ones,[2] the court stated:

"The position which this court . . . take[s] . . . is that since plaintiff was exchanging $100 debentures for preferred stock for which it had already received $100 in value, then plaintiff lost nothing as a result of the transaction. Since there was no actual difference between the face value of the debentures and the amount received in return for them ($100 preferred stock) there was no discount which could be amortized over the life of the bonds. The fact that the preferred stock had a market value less than the $100 at the time of the exchange is of no consequence in this type of transaction where the plaintiff is purchasing its own stock. What is important in this case is the value received for the stock at the time of its issuance." 422 F. 2d at 429.

However, it is important to note that the court did not rely on the principal or par value of the preferred stock in determining the value received by the corporation. Instead, it made an express finding that $100 was in fact the amount received at the issuance by the cancellation of $100 worth of debt. The court reserved the question of whether a bond discount would be allowable if the amount originally paid for the preferred stock had been less than $100. In discussing previous decisions, the Court of Claims distinguished the facts of *American Smelting*. It was a "crucial" difference that the exchange there had not involved the corporation's own stock but that of a subsidiary. The reasoning of *American Smelting* was also thought by the court to have been expressly overruled by its previous decisions in *Montana Power* and *Southern Natural Gas*. Similarly, *Industrial Dev. Corp.* and *Southern Fertilizer* were felt to be incorrectly decided and were rejected as authority.

In *Cities Service v. United States, supra*,[3] *Smelting* and *Nason Lens*, it was "well

[1] Pursuant to a taxable reorganization instituted under the Bankruptcy Act, taxpayer issued stock and 25-year 6% bonds with a par value of $100. In return, taxpayer assumed outstanding first mortgage bonds and received the predecessor's debentures and preferred stock. The fair market value of the assets received was claimed to be $71.50 for each exchange. The Commissioner allowed the amortization for the difference between par value and fair market value. Plaintiff then elected to redeem the bonds at face value before the expiration date and the discount not yet amortized was claimed as a deduction for that year. This was disallowed by the Commissioner.

[2] The holders of taxpayer's 5%, $100 par value preferred stock pursuant to an exchange offer approved by the ICC exchanged 277,762 shares thereof for a like number of 5% debenture in the principal amount of $100. The preferred stock was shown on taxpayer's books at full par value and was callable at par plus accrued and unpaid dividends. It was cancelled upon receipt. The total market value of the preferred stock at the time of the exchange was less than the maturity value of the debentures for which the shares of stock were exchanged, and this difference was claimed by taxpayer as bond discount.

[3] Taxpayer issued its thirty-year, 3½ debentures in the aggregate amount of $115,236,950. In return, it received all its outstanding no par preferred preference B and preference BB shares, all rights appertaining thereto and all dividend arrearages thereon. It was stipulated that the three classes of preferred and preference shares were issued by the plaintiff at various times in consideration for cash and properties, having an aggregate fair market value at the time of issuance of no more than $45,327,816.00. Further, it was agreed that at the time of the exchange the aggregate fair

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settled" in the Second Circuit that bond discount could occur in a bonds-for-property transaction. In blending the reasoning of both lines of cases, the court recognized that the conflict was more apparent than real. The difference between the face amount of the bonds issued for property and the market value of the property acquired was bond discount because it represents the cost of the money that would otherwise need to be borrowed in order to make a cash payment for the property received. Further, the court recognized that something other than a "mere reshuffling of assets" had occurred:

> "The effect of the exchange was a radical change in plaintiff's debt obligation. In lieu of a conditional obligation to pay dividends on the preferred and preference shares, depending upon earnings and the management's good faith exercise of its discretionary powers, plaintiff now becomes firmly and unconditionally obligated to pay the face amount of the new debentures plus 3% interest annually on the unpaid balance. . . . The 'expedient' in question, if it can be so called, involved far more than the substitution of currencies urged by the defendant. It involved the assumption of enlarged and unconditonal obligations by the plaintiff, as a result of which deductible losses have been realized." 316 F. Supp. at 72.

However, the original consideration of the shares received in the exchange was also recognized as a determinative factor. The court ruled that the minimum amount which could be ascribed to the shares acquired was the original consideration which had been received upon issuance. Having received the cost price upon issuance, the taxpayer could not sustain a loss to a greater extent. The original consideration was only the lowest figure at which the value could be established. The actual value could be determined only after a review of such factors as market value of the shares, the financial condition of the taxpayer at the time of the exchange, the prospects of profits and expert opinion. As a result, the motion for summary judgment was denied and a trial was directed to determine the value of the shares received.

[Discount in Stock-Bond Case]

Relying heavily on *Cities Service*, the Court of Claims in *Missouri Pacific Ry. Co. v. United States, supra*,[9] refused to adopt the position that no discount can arise on an exchange of bonds for the old securities of a corporation. It indicated that while the amount received for the old securities which are retired might be the minimal consideration or floor to be ascribed to the securities for purposes of calculating discount, it cannot be the ceiling. No trial was necessary to determine value since it had already been determined in the reorganization proceedings. The Court purported to follow its decision in *Erie Lackawanna*. However, market value was not considered "of no consequence" as in *Erie*, but instead was a "factor" which, although not conclusive, was still to be weighed in the analyses. Also, even though *Erie* had found *American Smelting* of no value as authortiy because of the "crucial" difference that the stock received there had been that of a subsidiary, the Court of Claims in *Missouri Pacific* announced a rule that applied to exchanges involving "shares of its own stock or stock of its subsidiaries." 433 F. 2d at 1325.

The Tenth Circuit had occasion to consider bond discount in a bonds-for-property situation in *Atchison, Topeka and Santa Fe Ry. Co. v. United States, supra*.[10] The fact that the Regulation concerning bond discount does not distinguish between bonds issued for cash and bonds issued for property was held to be a *sub silentio* recognition that discount could exist in both cases. Recognition of such a situation was thought to most conform the law with economic and

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market value of the preferred and preference shares was $86,313,600.00. Plaintiffs repurchased the debentures at face amount and claimed bond discount for the difference between that amount and either the original purchase price or the fair market value at the time of exchange.

[9] Taxpayer was reorganized pursuant to a plan approved by the ICC and its trustee under Sec. 77 of the Federal Bankruptcy Act. Collateral trust notes, first mortgage 4½% bonds, general mortgage 4½% income bonds, 5% series of debentures and stock was issued for its outstanding debt securities and stock of its subsidiaries. The difference in the aggregate maturity value of the new bonds and the fair market value of the old securities given in exchange was claimed by the taxpayer to be amortizable over the life of the bonds as original issue discount.

[10] Taxpayer was formed as the successor company to receive the assets of the old company pursuant to a court ordered sale of the assets during the course of a bankruptcy reorganization. The trial judge ruled that taxpayer issued bonds and securities in exchange for the bonds and securities of the old company. The issue on appeal was not the nature of the transaction—bonds for bonds or bonds for property—but only discount can arise in any bonds-for-property transaction.

business reality. The heavy burden of proof was satisfied by "substantial evidence from experts in railroad securities and properties who relied on the documents surrounding the reorganization, market conditions and actual trading, and valuation of the railroad properties." 433 F. 2d at 153. Since a bonds-for-property exchange was at issue, the court saw a conflict in the Third Circuit opinions of *American Smelting* and *Montana Power*. The earlier view of *American Smelting* was regarded as the more persuasive.

The most recent Court of Claims pronouncement in the bonds-for-stock area is *St Louis-San Francisco Ry Co. v. United States, supra.*" There, *Erie Lackawanna* and *Missouri Pacific* were regarded as binding authority. Original consideration value was not an issue, however, since the taxpayer did not contend that the maturity value of the debentures exceeded the amount it received when it issued the preferred stock. In discussing *Erie Lackawanna*, the court concluded that that case had "rejected the use of fair market value as a *determinative* measurement of debt discount when bonds were exchanged for preferred stock." (emphasis added) 28 A. F. T. R. 2d at 5345. The key element in that case was the value to the corporation of the stock received in the exchange. *Missouri Pacific* was also held to have rejected market value alone as determinative of the value of stock in favor of a consideration of all relevant information, including the market value, the financial conditions of the taxpayer, profit prospects and expert opinion. No trial was necessary, however, since a valuation of the shares had already been made.

[*Discount Based on Value Received*]

Besides *Southern Fertilizer*, the other decision by a District Court in the Fifth Circuit which has addressed the issue is *Claussen's Inc v. United States, supra.*" No claim was made in that case, nor proof offered, concerning market value. Instead, the taxpayer deducted the difference between the face value of the debentures and the value received for the exchanged upon issuance as amortizable bond discount. The court allowed the full discount, saying that the fact that the exchange is for the stock of the issuer rather than for cash is of no importance. *Missouri Pacific, Cities Service* and *Erie Lackawanna* were cited in holding that the measure of the bond discount is the difference between the par value of the bonds issued and the value of the stock to the taxpayer at the time of the exchange.

The Tax Court entered the fray concerning bonds-for-stock exchanges in the recent opinion of *National Alfalfa Dehydrating and Milling Co. v. Commissioner, supra.*" Citing *Erie Lackawanna* and *Missouri Pacific*, the decision appears to limit inquiry concerning value of the amount received by the taxpayer when the original stocks or bonds were issued. Further, the reasoning of the court harkened back to the "mere reshuffling of assets" viewpoint by characterizing the exchange from the corporations standpoint as "merely the exchange of one form of interest . . . for another." 40 L. W. at 2245. The Tenth Circuit opinion of *Atchison, Topeka and Santa Fe* was distinguished because in that case the only issue was whether bond discount could arise in a bond-for-property exchange and not whether the value of the stock was to be measured by the fair market value or by the consideration received at issuance.

The court, in reaching a decision in this matter, notes initially that it is not called upon to consider bond discount in a bonds-for-property transaction. The decisions dealing with this type of exchange, namely, *Montana Power Co. v. United States* [56-1 USTC ¶ 9402], 232 F. 2d 541 (3rd Cir. 1956), *Montana Power Co. v. United States* [58-1 USTC ¶ 9332], 159 F. Supp. 593 (Ct. Cl. 1958), *Nassau Lens v. Commissioner* [62-2 USTC ¶ 9723], 308 F. 2d 39 (2nd Cir. 1962), and *Atchison, Topeka and Santa Fe Ry Co. v. United States*, 71-1 USTC ¶ 9430 (10th Cir.

" In 1956, taxpayer exchanged its Series A, 5%, $100 par value income debentures, maturing on Jan. 1, 2006, plus cash and common stock for its outstanding Series A, 5%, $100 par value preferred stock. The transaction was considered a reorganization under Sec. 368(a)(1) of the Internal Revenue Code of 1954—a recapitalization under Sec. 368(a)(1)(E). Amortizable bond discount was claimed for the difference between the fair market value of the preferred stock and the maturity value of the debentures.

" Taxpayer issued two classes of common stock in 1954. In 1956 the shareholders approved a plan of recapitalization whereby each share of the outstanding common stock would be exchanged for ½ new share of common stock, a warrant to purchase ½ of a share of new common stock at $5.50 per share and a 6%, $10 debenture maturing in 40 years. The par value of the assets given to the old stockholders was $2,325,000. The value received for the A and B stock at issuance was $1,962,500. The difference of $362,500 was claimed as amortizable bond discount.

" In a 368(a)(1)(E) recapitalization, taxpayer exchanged bonds with a face value of $50 for preferred stock with a par value of $50 and cancelled the stock after the exchange. Taxpayer claimed the difference of face value and fair market value as amortizable bond discount.

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1971), therefore are inapposite to the present considerations.

[Stock Issuance Price]

This court is convinced that an exchange of a corporation's income debentures for its outstanding preferred stock is more than a "mere reshuffling of assets." Instead, a very basic transformation has occurred in the capital structure of the corporation. A creditor, with full rights, has been substituted for what had previously been one with owner interest in the company. An obligation to pay the face amount of the debentures plus the interest rate has been created from what once was a discretionary power depending only upon earnings and the good faith of management. Also, from the corporation's standpoint, a deductible yearly expense has been substituted for non-deductible dividend payments.

Since some transformation of the capital structure has occurred in both a bonds-for-cash exchange and a bonds-for-stock exchange, the court sees no reason why bond discount should occur in one and not the other. However, the court is not convinced that the market price should be the determinative measurement of bond discount. To the contrary, the arguments of *Cities Service Co. v. United States, supra*, are deemed the more persuasive. The issue price is the value assigned by the corporation to the stocks that it issues. Because of subsequent events in the marketplace which may tend to devalue the stocks, the corporation attempts through bond discount to assign a new value to the stocks. In so doing, the corporation is attempting to make use of losses which have been borne by its shareholders in the marketplace, thus, in essence, utilizing the loss a second time. This the court is unwilling to allow. In this line of thinking, the court joins with several previous decisions. *See, Erie Lackawanna Ry. Co. v. United States* [70-1 USTC ¶ 9245], 422 F. 2d 425 (Ct. Cl. 1970); *Missouri Pacific Ry. Co. v. United States* [70-2 USTC ¶ 9698], 433 F. 2d 1324 (Ct. Cl. 1970); *Claussen's Inc. v. United States*, 71-2 USTC ¶ 9632 (S. D. Ga. July 29, 1971); *Cities Service v. United States* [70-2 USTC ¶ 9537], 316 F. Supp. 61 (S. D. N. Y. 1970); *National Alfalfa Dehydrating and Milling Co. v. Commissioner* [CCH Dec. 31,030], 57 T. C. No. 6, 40 L. W. 2247 (Tax Ct. Oct. 14, 1971).

The decisions of *Erie Lackawanna*, as explained by *Missouri Pacific and St. Louis-San Francisco Ry. Co.*, and of *Cities Service* are further followed to the extent that proof of market value is considered important in establishing that the value of the stock to the corporation might be greater than the issue price. Since the only value in the facts now before the court is the stated price of the stock, a hearing is necessary to make a determination as to the correct fair market value of the stock at the time of the exchange. According to *Cities Service*, the original issue price of the stock must be ascertained as well.

Several of the previously discussed cases are distinguishable from the present one and thus not in conflict with it. There was no original issue price in *American Smelting* because the exchanging corporation received the shares of a wholly-owned subsidiary. Therefore, the market value was the only one with which the court could measure bond discount. Similarly, *Southern Fertilizer* and *St. Louis-San Francisco Ry. Co.* did not consider the issue price. In the former case, the value of the stock was stipulated and in the latter, the taxpayer did not contend that the maturity value of the debentures exceeded the amount it received when it issued the preferred shares. The rationale of *Southern Natural Gas* also is of no consequence because here the stock received in the exchange was retired. The pivotal point in *Southern Natural Gas* was that the stock was retained and so could not be valued.

Therefore, pursuant to Rule 56(d), F. R. Civ. Proced., it is hereby ORDERED, ADJUDGED, and DECREED that no genuine issues exist as to the plaintiff's claim except as indicated. The measurement of bond discount shall be the difference between the issue price originally received by taxpayer for the preferred stock and the par value of the bonds, except if it can be shown that the fair market value of the preferred stock at the time of the exchange was greater than the issue price. Then, the bond discount shall be the difference between the fair market value of the preferred stock and the par value of the bonds. Provided however, that no bond discount shall exist if either the issue price or the fair market value of the preferred stock exceeds the par value of the bonds. Evidence as to the issue price of the preferred stock and the fair market value of the preferred stock shall be received by this court after which time a determination as to bond discount shall be made.

APPENDIX G

railroad corp. for bonds issued by it upon receipt of its preferred stock pursuant to reorganization plan in which taxpayer was surviving company. Since fair market value per share of preferred stock was greater than bond issue price, there was bond discount. Bond discount measured as difference between fair market value of preferred stock at time of exchange and par value of bonds. *Reference:* 1973 P-H Fed. ¶7350. '54 Code Sec. 61.

2. LOSSES—Specific types of property—other property or enterprises. Loss deduction denied railroad corp. for railroad grading. Uses and potential uses of grading negated claim of abandonment. *References:* 1973 P-H Fed. ¶ 14,251; 15,433. '54 Code Secs. 165, 167.

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* * *

J. N. Ogden, W. H. Sanders, W. A. Kimbrough, P.O. Box 1828, Mobile, Ala., R. T. A. Molloy, James L. Boring, 1911 N. Fort Myer Dr., Arlington, Va., Attys. for Plaintiff.

C. S. White-Spunner, Jr., U.S. Atty., 311 Fed. Bldg., Mobile, Ala., Donald B. Craven, John P. Downer, Attys., Tax Div., Dept. of Justice, Wash., D.C., for Defendant.

Judgment And Decree

These consolidated actions for the refund of income taxes plus assessed and statutory interest paid by the Gulf, Mobile and Ohio Railroad (hereinafter "taxpayer") were heard by this court sitting without a jury.

These civil actions are brought under Section 1346(a)(1) of Title 28 of the United States Code for the recovery of Federal income tax and interest assessed on such tax (plus interest on any recoveries allowed herein as provided by law) paid by the taxpayer for the calendar years 1959 and 1961.[1]

The taxpayer is a corporation duly organized and existing under the laws of the State of Mississippi and maintains its principal office and place of business in Mobile, Alabama.

It was, during all pertinent and relevant periods, engaged in the railroad business as a common carrier in the transportation of persons and property in interstate commerce and is subject to the jurisdiction of the Interstate Commerce Commission (hereinafter referred to as ICC).

The issues heard by the court and which are now to be decided are:

(1) whether taxpayer is entitled to deductions in 1959, 1961, and 1964 for bond discount allegedly arising from the exchange to

¶ 73-348

GULF, MOBILE AND OHIO RAILROAD COMPANY, PLAINTIFF v. U.S., DEFENDANT. U.S. District Court, S. Dist. of Ala., S. Div. Civil Action Nos. 5662-69-P, 6332-70-P. Nov. 27, 1972. Year 1972. Decision for taxpayer in part and for Govt. in part.

1. INCOME—Corporation's transaction in own bonds—discount on bonds issued for property. Bond discount deduction allowed

[1] The years 1959 and 1961 are the only ones at issue since the deductions claimed with respect to the year 1964 gave rise to a net operating loss for that year which plaintiff has carried back and claimed as a deduction for the year 1961.

its shareholders of its 5% income debenture having a maturity value of $100 each for a like number of its no-par preferred stock, $5.00 Series, with a stated value of $100 per share; and

(2) whether taxpayer is entitled to deductions on its returns for certain railroad grading located in the State of Illinois which it allegedly retired and abandoned in the years 1961 and 1964.

I. Bond Discount Issue

Upon defendant's Motion for Partial Summary Judgment and plaintiff's Cross Motion for Partial Summary Judgment, this court ruled that as a matter of law bond discount can arise when a corporation issues its income debentures in exchange for its already outstanding preferred stock. G.M.&O. v. U.S., 339 F.Supp. 489 [29 AFTR 2d 72-1075] (S.D. Ala. 1972). The determination of whether the bonds were issued at a discount was held to be a factual one which must be made on a case by case basis. The standards for such a determination were established by this court as follows:

> "The measurement of bond discount shall be the difference between the issue price originally received by taxpayer for the preferred stock and the par value of the bonds, except if it can be shown that the fair market value of the preferred stock at the time of the exchange was greater than the issue price. Then the bond discount shall be the difference between the fair market value of the preferred stock and the par value of the bonds. Provided however, that no bond discount shall exist if either the issue price or the fair market value of the preferred stock exceeds the par value of the bonds."

The issue before the court thus becomes whether the taxpayer has sustained his burden of proof in this instance as to the issue price originally received for the preferred stock and its fair market value at the time of the exchange. Before a discussion is undertaken as to this issue, however, a recitation of the relevant circumstances involved in the various transactions should be helpful.

The preferred stock in question was originally issued pursuant to a plan of reorganization formulated under the supervision of this court. Prior thereto, on June 3, 1932, this court had appointed receivers for the purpose of operating the properties of the Mobile and Ohio Railroad Company (hereinafter referred to as M&O). The plan of reorganization, which was approved by the ICC on October 13, 1939, contemplated the unified operation of the properties of the M&O and the properties of the Gulf, Mobile & Northern Railroad Company (hereinafter referred to as the GM&N) and the New Orleans Great Northern Railway Company (hereinafter referred to as NOGN). In the formulation of the plan, a new corporation, the taxpayer herein, had been formed on November 10, 1938, for the purpose of acquiring and operating these properties.

On June 14, 1940, this court entered a Final Judgment and Decree of Foreclosure and Sale of the properties of the M&O over which it had supervision pursuant to the equity receivership proceedings. Pursuant to that judgment, on August 1, 1940, the properties of the M&O were purchased at foreclosure sale by the M&O bondholders reorganization committees, free and clear of the various liens of its funded debts, except equipment obligations, which were to be assumed by the new corporation, the taxpayer. The total purchase price for the properties was $13,411,000. The sale was subsequently confirmed by this court in equity on August 22, 1940. On September 4, 1940, the bondholders' reorganization committee conveyed these properties to taxpayer in exchange for its issuance of the following securities:

(a) For each M&O $1,000 Refunding and Improvement Gold 4½'s, Series of 1977, due September 1, 1977, GM&O issued:
(1) $300 face value First and Refunding Mortgage 4's, Series B due July 1, 1975;
(2) $200 face value General Mortgage Income 5's, Series A due July 1, 2015;
(3) 6.25 shares of preferred stock;
(4) 12.5 shares of common stock; and
(5) Cash.

(b) For each M&O $1,000 5% Gold Note due September 1, 1938, GM&O issued:
(1) $350 face value First and Refunding Mortgage 4's, Series B due July 1, 1975;
(2) $250 face value General Mortgage Income 5's, Series A due July 1, 2015;
(3) 7.75 shares preferred stock;
(4) 15.5 shares of common stock; and
(5) Cash.

(c) For each M&O $1,000 Montgomery Division First Mortgage 5% due 1947, GM&O issued:
(1) $500 face value General Mortgage Income 5's, Series A, due July 1, 2015;
(2) 6.5 shares of preferred stock; and

(... 13 shares of common stock.

Shortly ...ter taxpayer's purchase of the assets of th... M&O, it was consolidated with the GM&N ...rsuant to the plan of reorganization. The ...xpayer was the surviving company. The ...llowing exchange was effected by the con...nies:

For each ...hare of GM&N $100 par value, 6% pref...ed stock, including accumulated divi...ds which amounted to 72%, GM&O ...ued:
(1) 1 sh... of preferred stock; and
(2) 1.5 ...es of common stock.

The pla... reorganization also provided that the ...xpayer was to acquire the GM&N's l... said interest in the NOGN by issuing its ...rities for those of the NOGN. The exchan... provided:

For eac... $1,000 5% Income Debenture of the NO... the GM&O issued:
(1) 10 ... of preferred stock; and
(2) 71.... es of common stock.

The de... of the exchange in the years 1957-1962 ...t out in this court's earlier ruling, G.M... v. U.S., 339 F.Supp. 489 [29 AFTR 2d ...1075] (S.D. Ala. 1972). It is sufficient ... purposes here to state that the taxpayer ... its 5% income debentures having a m... ity value of $100 upon receipt of its pref... stock which had been issued in the abo... mailed transactions.

The co... ruling of February 18, 1972, setting out ... the taxpayer prove both the exchange v... and the original issue price of the preferr... ...ck, was an acceptance of the reasoning ... District Court in Cities Service Comp... United States, 316 F.Supp. 61 [26 AF... 70-5378] (S.D.N.Y. 1970). In that ca... the fair market value of the stock exch... for the debentures was established ... as to the aggregate closing market pri... the shares on the day before the exchan... adjusted by an expert appraisal of ... ares to eliminate the effects of the im... exchange. The original issue price ... shares, however, was to be determined ... a separate hearing after consideration ... "market value of the shares, ...ndition of the taxpayer at the time of th... change, its profits prospects and experi...ion." Id., at 73.

The ev... presented in the hearing of this case o... fair market value of the preferred stoc... the 1957-1962 period consisted of the ... ted market price (Joint Exhibit 1), e... opinion testimony and exhibits. The ...ated market price of $55% per share ... preferred stock surrendered was an ave... of high and low prices on the New York ... Exchange on the date that exchanges ...ted, or if no sales took place on that date, on the last preceding date on which sales were reported. This expert opinion was based upon market analysis of comparable railroad securities (Plaintiff's Exhibit B) and took into account the future prospects of the railroad, the priority of the preferred stock, the earnings of the preferred during the period and the attitude of the investors toward railroad securities.

Part of the controversy in this action centers around the proof of the issue price originally received by the taxpayer for the preferred shares. It is the defendant's position that the preferred shares were originally issued for the assets and not the stock, bonds, or other securities of the M&O. In either case, whether stock, etc., or assets were received, the defendant maintains that taxpayer has not met its burden of proof in this instance and should be allowed no bond discount.

[1] Defendant's contention concerning the true nature of the exchange between the GM&O and the M&O was before the Tenth Circuit Court of Appeals in Atchison, Topeka and Santa Fe Railroad Company v. U.S., 443 F.2d 147 [27 AFTR 2d 71-1587] (10th Cir. 1971). On facts resembling those now at bar, that Court ruled "especially in reorganization cases the end result of the series of interrelated steps controls the tax consequences of the whole." Id., at 151. Accord, Davant v. C.I.R., 366 F.2d 874 [18 AFTR 2d 5523] (5th Cir. 1966), cert. den. 87 S. Ct. 1370, 386 U.S. 1022, 18 L.Ed.2d 460, rehearing den. 88 S. Ct. 14, 389 U.S. 893, 19 L.Ed.2d 203; Liddon v. C.I.R., 230 F.2d 304 [49 AFTR 231] (6th Cir. 1956), cert. den. 77 S. Ct. 34, 352 U.S. 824, 1 L.Ed.2d 48; Budd International Corp. v. C.I.R., 143 F.2d 784 [32 AFTR 1071] (3rd Cir. 1944), cert. den. 65 S. Ct. 562, 323 U.S. 802, 89 L.Ed. 640.

Although it was recognized that the mechanics of an insolvency reorganization ordinarily involves a purchase of the old company's assets by the new company, the essential agreement between the new company by the reorganization's committee, who were the purchasers, and the security holders had to do with what the security holders should receive, to wit, the stock, from the new company for giving up their intangible claims against the old company. New York, C. & St. L. R. Co. v. Burnet, 64 F.2d 152 [12 AFTR 2d 383] (C.A.D.C. 1933) was distinguished in that it was decided before the step-transaction doctrine became established.

A close review of the Plan of Reorganization (Joint Exhibit 2) reveals that the reasoning of the Santa Fe case is especially applicable here. In that agreement, the reorganization committee was given all necessary powers (pg. 18) and assumes the

liability (pg. 25) to carry out the purposes of the agreement. Those purposes, as stated on page 4, are:

> "(a) Reorganization of M&O whereby a newly organized corporation to be known as Gulf, Mobile and Ohio Railroad Company (below referred to as the "New Company") will acquire all or substantially all of the properties of M&O presently held by its Receivers.
>
> . . .
>
> (b) Unified operation by the New Company of such M&O properties and the properties of GM&N and NOGN."

Thus, it is apparent that from the very inception of the plan, any purchase by the reorganization committee was intended to be only a tentative arrangement until the final transfer to the GM&O could be accomplished, and it would not be contrary to sound reasoning to hold the preferred shares were originally issued in exchange for the securities of the M&O, the GM&N, and the NOGN.

The taxpayer offered evidence that the fair market value of the preferred stock was $70.00 per share at the time of the 1957-1962 exchange. (The court hereinafter in this decree finds that the fair market value of preferred stock during 1957-1962 was $80.00 per share.) It then introduced evidence showing that the price originally received for the preferred was less than that figure. Charts were introduced which, using the monthly N.Y.S.E. quotations from January, 1930 through September, 1940, established the market value of the securities received for the GM&O preferred stock as follows (Plaintiff's Exhibit D):

(a) M&O Securities	
5% secured notes	$421.25
Ref. & Imp. Mtg. Bonds	352.50
1st Mtg. 5%, Montgomery Div.	261.25
(b) NOGN Securities	
4% Income Debentures	100.00
(c) GM&N Securities	
6% preferred stock, $100 par	11.00

Based upon these market quotations, even if the GM&O preferred stock were the only things given in return for each of these securities, which, of course, they were not, the issue price was much less than $80.00 per share.[1]

The taxpayer's expert testified that in his opinion the allocable fair market value of the securities received by the GM&O upon the issuance of its preferred stock was approximately $9.50 to $11.00 per share, which the court accepts. His testimony was based upon the market quotations of the securities of the constituent corporations prior to the consummation of the reorganization (Plaintiff's Exhibit D), the market quotations of the securities of the GM&O after issuance (Plaintiff's Exhibit D), the earnings record of the constituent corporations prior to the consummation of the reorganization in 1940 (Joint Exhibit 11), and the price earnings ratio of other railroads as compared with those of the constituent corporations (Plaintiff's Exhibit E). This evidence attempts to comport with the guidelines of Cities Service, supra, at 73, that the relevant considerations should be the "market value of the shares, the financial condition of the taxpayer at the time of the exchange, its profits prospects and expert opinion."

Even if held that the GM&O preferred stock was exchanged for the assets of the M&O, there seems to be ample evidence for a finding that the issue price was much less than the fair market value of $80.00 per share. The upset price set by this court before the judicial sale (Joint Exhibit 7), the bid price at the sale (Joint Exhibit 7), and the Internal Revenue Service Ruling of 1942 (Joint Exhibit 10) establishing the base of the properties, all give values less than that figure. In fact, the only evidence which tended to establish a higher valuation for the property was a determination by the ICC that the issue price for the preferred stock was $100.00 per share. This determination was based upon the book value of the assets being purchased by the GM&O. While an evaluation of assets at the time of the exchange might be persuasive to the court, a valuation based upon the generally unrealistic book value is deemed to be of little or no probative value and is not persuasive here.

Defendant would have the court rule that there has been a failure by the taxpayer to

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[1] 25 shares of GM&O preferred in exchange for each M&O Ref. & Imp. Mtg. Bonds at $352.50 per bond results in an issue price of $56.40 per share.

7.75 shares of GM&O preferred in exchange for each M&O 5% secured at $421.25 per share results in an issue price of $54.35 per share.

6.5 shares of GM&O preferred in exchange for each M&O 1st Mtg. 5%, Montgomery Division, at $261.25 per share results in an issue price of $40.18 per share.

10 shares of GM&O preferred in exchange for each NOGN Income Debenture at $100 per share results in an issue price of $10 per share.

1 share of GM&N preferred in exchange for each GM&N preferred at $11.00 per share results in an issue price of $11.00 per share.

prove the consideration originally received by the GM&N upon issuance of its preferred stock subsequently exchanged for taxpayer's preferred in the 1940 reorganization. Such a ruling would require a taxpayer to trace each stock back to its original cash or property exchange. This burden is practically impossible in view of the history of relatively frequent railroad reorganizations and stock transfers.

Finally, defendant contends that taxpayer has not met its burden of proof because it did not establish the precise number and origin of the preferred shares received by it in exchange for the debentures. Specifically, no evidence was offered concerning the 705 shares of preferred stock issued after the offer of reorganization and before the exchange offer in 1957. Also, it was established that taxpayer's expert, in his analysis, did not attempt to determine whether 986⅔ shares of preferred stock which were reacquired and cancelled before the 1957 exchange offer were originally issued for the securities of the M&O, the GM&N, or the NOGN.

A method of proof by which each individual share of stock is accounted for and individually traced through the myriad of reorganizations and exchanges would undoubtedly be the most desirable and helpful to the court. However, in the context of this case, with a total of 283,483⅓ shares of stock outstanding, and the wide disparity between the established fair market value of the preferred stock in 1957-1962 and the issue price in 1940, the failure to determine precisely the effect of these stocks is not deemed to be significant.

The court, as the trier of facts, which includes an evaluation of the witnesses and their evidence, finds the fair market value of the preferred stock per share to have been $80.00.

The plaintiff's expert has been a paid consultant of the plaintiff for many years. After careful questioning by the court under certain hypothesized facts, it is the court's judgment that there is an understandable conservative bias in favor of the plaintiff which tips the balances of his judgment to a posture unduly favorable to the plaintiff. The court's rule as to the means of determining the measurement of bond discount in its order on motion for partial summary judgment should be qualified in its application to the particular facts of this case. When a company, as the plaintiff here, is seeking to obtain all of it outstanding preferred stock by an exchange and where it is likely that as much as two-thirds of that stock will be obtained, as occurred in this case, a situation is brought into being different from the usual buying and selling in relative small blocks as takes place day to day on the stock exchange. It is rather obvious that the company stood in a position of preferred expertise and knowledge which was not shared by the average stockholder.

The Government's expert, assuming a tax bracket of 52% for the plaintiff and taxable earnings every year for the life of the bonds, calculated that the stock was worth to the plaintiff up to $121.58 and not less than $100 per share. It is a calculation based on optimum conditions. The $121.58, of course, does not anticipate a loss for any year. We know this is contrary to what has happened since the exchange took place. On the other hand, the taxpayer's expert testified the effect of the huge tax benefits possible to the taxpayer as being miniscule in projecting the market value of the stock at $70.00 per share, completely discounting the taxpayer's obvious advantage in paying upwards of $100.00 per share if necessary to obtain the stock.

Apparently, the taxpayer did not anticipate a bond discount savings at the time of the exchange nor until two or three years had elapsed thereafter. It is clear the stockholders were not informed and did not anticipate a possible tax liability to them in the event of a bond discount.

An additional factor stressed by the Government must enter into a figure of fair market value in this case. Any bond discount granted to the taxpayer could result in ordinary income and therefore additional tax liability of the shareholders who participated in the exchange. This created an upward thrust to the fair market value of the stock most difficult to assess. The equities between the taxpayer and the stockholders must not be overlooked.

A similar equitable situation arose and was the basis of the Court of Claims decree in Bethlehem Steel v. U.S., 26 AFTR 2d 70-5021 [70-5028] denying an interest deduction. In view of the lack of evidence that a significant saturnine would have resulted had these facts pertaining to a bond discount been known, this consideration should not compel an outright denial of a bond discount in this case.

In projecting the market value of the stock at the time of the exchange by adjusting the rule of measurement set out by this court in its summary judgment order to the evidence as above evaluated, the court finds that if there is to be a willing buyer in full knowledge of all factors affecting the market price and a willing seller with the same information and neither acting under compulsion and operating on a free market, " the value of the stock would necessarily have been higher

" [P]rice at which the stock would change hands between a willing buyer and a willing seller, neither of whom is under any compulsion to buy or sell and both of whom are reasonably well informed as to the facts having a bearing on value." Bader v. U.S., 172 F. Supp. 831, 836 [3 AFTR 2d 1824] D.C.

than that estimated by the plaintiff's expert. In further consideration of the equities between the taxpayer and the stockholders, the Court has adjusted that figure upwards to $80.00.

Therefore, it is this court's determination that the taxpayer has met the burden of proof established in its February 18, 1972 order. Furthermore, since the $80.00 fair market value per share of preferred stock at the time of this exchange was greater than the issue price of approximately $11.00 per share, the measurement of bond discount here is the difference between the fair market value of the preferred stock at the time of the exchange and the par value of the bonds.

A bond discount was realized by taxpayer upon the issuance of its 5% income debentures having a maturity value of $100.00 in exchange for a like number of its no-par preferred stock, $5 Series, with a stated value of $100 per share. The bond discount shall be calculated as the difference between the fair market value of the preferred, or $14,-999,280, and the par value of the bonds which were issued in exchange thereof, $18,-711,600, or a total discount on the exchange of $3,742,320.

II. Abandonment of Grading Issue

During the period 1959-1964, plaintiff installed a centralized traffic system on various segments of its mainline track located in the State of Illinois. Prior to installing this system, the plaintiff used two separate tracks, northbound and southbound, over which its trains passed. As a result of installing the new system, plaintiff needed only one line of track so rails, ties, and some ballast of one line of track were taken off during the years 1961-1964, leaving only one line of track where there had been two.

Plaintiff contends that when the second line of track was removed, the underlying grading associated with such track was permanently retired or abandoned and since such grading is property used in a trade or business, it should be allowed a reduction under Section 167 of the Code or an abandonment loss deduction under Section 165 of the Code. There is approximately 42 miles of roadbed involved. All 42 miles of the claimed abandoned roadbed runs parallel to the single remaining track. The cross section of both tracks is one unit and constitutes one bed save and except one portion of 3.3 miles near Springfield where the single bed and double tracks divide into separate beds and single tracks. The defendant has permitted a deduction for this limited area where the tracks separated and did not comprise a single unit.

The single roadbed carrying two tracks from which one was removed, and the proximity of the vacated portion of the bed to the remaining mainline track, if not precluding a concept of abandonment, militates to such an extent against a concept of abandonment that the court is not persuaded by a preponderance of the evidence that there has been an abandonment.

The minimum industrywide cross-section of a roadbed for a single track is 21½ feet for fills and 40 feet for cuts. The roadbed for the dual track on an average was 30 to 32 feet for fills and 52 feet for cuts. On all of the areas claimed by the plaintiffs, it is contended that they have abandoned the adjacent roadbed and are now only using 21½ feet of the fills and 40 feet of the cuts and the excess should be considered as abandoned.

There is some movement, although not prevalent industrywide, toward the recognition of wider roadbeds, to wit, 26 feet for new construction.[3]

It is undisputed that the claimed abandoned roadbed would deteriorate very little, if any, for many years, and, in effect, has an indefinite life. The claimed abandoned area aids and facilitates drainage. The wider cuts minimize rock, earth and other vegetation from falling on the remaining track. Although there does not appear to be daily, weekly, or even monthly, use of many areas of the claimed abandoned track for off-track maintenance, there is clear evidence of vehicular use for maintenance in certain areas by reason of field road type vehicle tracks on the claimed abandoned roadbed at several intervals.

Several witnesses, of which one was plaintiff's expert, from spot checks on four separate occasions, testified some use was being made of the claimed abandoned track in connection with the existing track. The very

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1959)

[P]rice which willing buyer would pay to willing seller, neither being under compulsion to buy or sell, and both having full knowledge of all pertinent facts." In re Powell's Estate, 282 P 2d 163, 168 (Cal. App. 1955)

[3] Defendant's expert, Caywood, a Chief Engineer of Audubon, Ohio, joined in such a recommendation in 1964, plus a 12 foot access road when practical. The New York Central in the 1960's, in the reconstruction of a new single roadbed, constructed it wider than the dual track roadbed in the instant case to provide for the movement of off-track motor vehicles, maintenance and repair equipment, and to minimize the danger of rock falls, etc. in cuts.

presence of the firm roadbed immediately adjacent to the existing track invites use over the years. It will undoubtedly be used in the event of derailments, for open storage of crossties and other maintenance equipment.

The use of a single track to carry trains which formerly operated on two tracks has substantially increased the need for maintenance on the single track. The wider roadbed sought to be abandoned provides a safe area for maintenance workers and material and equipment without the necessity of trains using the track reducing their speed.

Although signal towers at intervals of approximately one mile have been moved onto portions of the former track area, the entire remaining track runs through relatively flat or slightly rolling type terrain. Vehicles can easily pull around the signal towers.

The evidence is uncontradicted that there is an existing public highway which runs parallel and within a relative few feet of most of the track with numerous crossings to the opposite side. These crossings afford ready access for off-track motor vehicles for maintenance work. This greatly minimizes the interrupting effect of the signal towers at mile intervals.

The plaintiff has recognized and expressed an intention to use the double track area in communications to the Highway Planning Authorities in the State of Illinois in connection with the construction of bridges. It has repeatedly insisted that the piers of the overhead roads constructed by the State give full clearance to the double track area and cited specifically the future possible use of the roadbed for the construction of highspeed trains in connection with nationwide "Railpacks."

[2] The court concludes that the uses and potential uses negate the claim of abandonment, and, to the contrary, clearly show the taxpayer continues, and will continue, to derive considerable benefit from the alleged abandoned roadbed.

This court agrees that:

"Not until there has been a complete and permanent retirement or abandonment of the grading would the taxpayer be allowed a deduction under either §167 or §165. A mere lessening or decline in the value of an asset to a taxpayer by reason of excess capacity does not create a deductible loss." Western Maryland Railway Co. v. U.S. 291 F.Supp. 935, 940 [23 AFTR 2d 69-547] (D. Md. 1968), Maryland C. Ct., p. 940, citing Reporter Publishing Co. v. Commissioner, 201 F.2d 743, 744 [43 AFTR 224] (10th Cir. 1953), cert. den. 345 U.S. 993, 73 S. Ct. 1133, 97 L. Ed. 1401 (1953); New York Sun, Inc. v. Commissioner, 27 T.C. 319, affirmed per curiam, 253 F.2d 487 [1 AFTR 2d 1205] (2d Cir. 1958).

All that has been shown by the facts is a decrease, albeit substantial, in the use of the claimed abandoned property. The grading and improvement of the roadbed are in place available for use by the railroad. It is being used by the railroad, and unquestionably will be used in the future to a varying extent depending on many factors which indicates a use of more than incidental value to the plaintiff.

It is therefore Ordered, Adjudged and Decreed that the taxpayer is entitled to, and a judgment is hereby rendered for the plaintiff and against the United States of America for, recovery of Federal income tax and deficiency interest thereon, for the taxable year ending December 31, 1959 and December 31, 1961, arising from a bond discount as hereinbefore set out in this decree.

It is further Ordered, Adjudged and Decreed that the taxpayer is not entitled to deductions on its returns for the years claimed for certain railroad grading located in the State of Illinois which it claimed was retired and abandoned, therefore, it is Ordered, Adjudged and Decreed that judgment be, and is hereby, entered for the defendant on this issue.

Costs are taxed against the defendant.

¶ 73-349

Dr. Hollis K. (III) and Patricia D. LEATHERS, APPELLEES v. U.S., APPELLANT. Dr. William F. and June B. Blankenship, Appellees v. U.S., Appellant. U.S. Court of Appeals, Eighth Circuit. Nos. 71-1647, 71-1648. Dec. 20, 1972. District Court, 28 AFTR 2d 71-5458, affirmed. Years 1968-1969. Decision for taxpayer. 471 F. 2d 856.

1. INCOME EXCLUSIONS—Scholarship and fellowship grants—trainee's services. Exclusions allowed resident physicians for amounts received from medical center. Medical center is primarily teaching institution. Residents not required to stay in state after completion of residency training. Work could have been performed without residents. *Reference:* 1973 P-H Fed. ¶8630(5). '54 Code Sec. 117.

Byron M. Eiseman, 1100 Boyle Bldg., Little Rock, Ark., Atty. for Appellees.

Carolyn R. Just, Atty., Dept. of Justice, Wash., D.C., for Appellant.

APPENDIX H

Internal Revenue Code of 1954 (26 U.S.C. 1964 ed.):

SEC. 163. INTEREST.

(a) GENERAL RULE.–There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

* * *

APPENDIX I

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

SEC. 1.163-3 *Deduction for bond discount.*

(a) *Discount upon issuance.* (1) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. ***

* * *

SUPREME COURT, U. S.
DEC 28 19
MICHAEL RODAK, JR.

IN THE

Supreme Court of the United States

OCTOBER TERM 1973

No. 73-9

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

v.

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF *AMICUS CURIAE* OF CITIES SERVICE COMPANY

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IN THE

Supreme Court of the United States

OCTOBER TERM 1973

No. 73-9

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

v.

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF *AMICUS CURIAE* OF CITIES SERVICE COMPANY

Statement of Interest of the *Amicus Curiae*[1]

Cities Service Company, *Amicus Curiae* herein by consent of the parties, is a corporation validly organized and incorporated under the laws of the State of Delaware with its principal office in New York, New York. In May, 1947, pursuant to an order by the Securities and Exchange Commission which was acting under the authority of the Public Utility Holding Company Act of 1935, Amicus exchanged its three percent, sinking fund, thirty year debenture bonds in the principal amount of $115,246,950 for its outstanding cumulative preferred and preference stocks

[1] Both Petitioner and Respondent have consented to the filing of this Brief. Their letters of consent have been filed with the Clerk.

having an aggregate par value of $58,690,000 and for which it had received on issuance $45,323,846.

In 1967, Amicus instituted an action for refund of Federal income taxes for 1953 and 1954 on the grounds that the debentures were issued at a discount which should be amortized annually, or that Amicus was entitled to a deduction for loss on retirement of the debentures due to the discrepancy between the principal amount of the debentures and their issue price. On June 11, 1973, the United States District Court for the Southern District of New York held that the "issue price" of such debentures for purposes of determining the application of Treasury Regulations 118, Section 39.22(a)-17 of the Internal Revenue Code of 1939 (Treasury Regulations Section 1.61-12; Section 1232(b)(1), Internal Revenue Code of 1954) was the fair market value of the preferred and preference shares at the time of the exchange. The Court found such issue price to be $86,313,600. *Cities Service Co.* v. *United States,* 362 F.Supp. 830 (S.D.N.Y. 1973).

Amicus, Cities Service Company, believes that the question of the issue price of bonds issued by a corporation is entirely one of fact peculiar to each issuance, but Amicus is concerned that the petitioner herein has brought the question before this Court in such manner as to induce the Court to go beyond the case before it and rule that, as a matter of *law,* the "issue price" cannot be less than the principal amount of the bonds issued unless the bonds are issued in exchange for an immediate cash payment in an amount less than such principal amount, or rule that regardless of the issue price, there can be no discount at any time unless such cash is exchanged. Such a ruling would be unwarranted in view of the Treasury Regulations and Sections 163 and 165 of the Internal Revenue Code and would be directly contrary to long established case law and the recent expression of Congress contained

in Section 1232(b) of the Internal Revenue Code as amended by Section 413 of the Tax Reform Act of 1969, P.L. 91-172, 83 Stat. 487, which was considered a clarification of existing case law when passed by the Congress. See, Senate Report No. 91-552, 91st Cong. 1st Sess. p. 148, 1969-3 Cum. Bull. 423, 516; House Report No. 91-413 (part 1) 91st Cong. 1st Sess. p. 109, 1969-3 Cum. Bull. 200, 268. It should be noted that in 1969 Congress was primarily concerned with the inclusion of the discount in the income of the recipient bondholder.

Amicus also believes that the petitioner, although alleging that a conflict exists between the decision of the United States Court of Appeals for the Tenth Circuit in this case and the decisions of the United States Court of Claims, which petitioner deems to be correct, i.e., *Erie Lackawanna Railroad Company* v. *United States,* 422 F.2d 425 (Ct. Cl. 1970); *Missouri Pacific Railroad Company* v. *United States,* 427 F.2d 727 (Ct. Cl. 1970), modified 433 F.2d 1324 (Ct. Cl. 1970), *certiorari* denied 402 U.S. 944; and *St. Louis-San Francisco Railway Co.* v. *United States,* 444 F.2d 1103 (Ct. Cl. 1971), *certiorari* denied, 404 U.S. 1017, is seeking to induce this Court to go far beyond the question in the instant case and declare a new rule of law which would invalidate, *in futuro,* the statements by the Tax Court and the Court of Claims as to the proper method by which the issue price of bonds is to be determined when the immediate exchange is not entirely of cash for the bonds, even though such method is not before this Court and has not yet been directly ruled upon by any court and even though the instant case neither warrants nor requires such extreme rule. Amicus believes that such a declaration would be outside the scope of the instant case, would be contrary to statutory and case law, would constitute, in effect, the issuance of a declaratory judgment on a tax question, and would deprive other taxpayers of an opportunity to present their cases on their

merits and to be judged on the basis of the facts peculiar to their particular cases.

Question Presented

What is the "issue price" of bonds which are exchanged for a consideration other than immediate cash payment?

Summary of Argument

I. The petitioner in this case, the Commissioner of Internal Revenue, has misconstrued the entire concept of bond discount, especially as provided for in the Treasury Regulations.

Bond discount is not some mysterious, esoteric concept which depends for its existence upon the configuration of certain subjective criteria at some particular time or place. Bond discount is merely the difference between the principal amount of a bond and its issue price, and such "issue price" is, as a matter of fact, only the amount in money or money's worth received for it.

Arguments and contentions regarding the nature of the transaction in which the bond was issued, the time of the issuance, the character of the consideration received for the bond, the time of the receipt of the consideration, or whether or not the consideration is "new money", are not germane or material to the question of issue price, which is simply one of value or valuation. Characterizing or denominating the exchange as a "recapitalization" or a "reshuffling of a capital structure" or questioning whether or not the consideration received constitutes property obscures and thereby avoids scrutiny of the real question in such cases, which is simply the *value received* for the bonds.

II. The petitioner in this case is asking the Court to decide more questions and broader questions of fact and of law than are necessary to resolve the issue presented in this case.

In effect, the petitioner is asking the Court to decide issues not yet directly presented to the courts and thereby deprive the taxpayers concerned of an opportunity to properly present their cases and have them adequately considered by the courts. Adoption of petitioner's contentions would have the effect of the issuance of a declaratory judgment which is prohibited in tax cases.

ARGUMENT

A. *The issue price of a bond is the dollar value of the consideration received for it.*

There is nothing esoteric about the nature of bond discount. It is merely the difference in money value between what is received for bonds and the amount which must be repaid by the obligor upon maturity of the debt. The consideration may be money or property or both, but the nature of the consideration is irrelevant. It is not the nature of the consideration or the timing of the exchange which determines bond discount; it is the *value* of the consideration which governs.

Value is indisputably a question of the peculiar facts and circumstances of each debt issued by each debtor. If a corporation issues a bond receiving in exchange less value than it will be obligated to repay at the maturity of the obligation, it suffers, or will suffer, an economic loss, which if incurred in a trade or business should be deductible for income tax purposes. The Treasury Regulations have so provided since 1918. Whether the deduction is to be amortized over the lives of the bonds or deducted upon

their retirement are questions only of timing—they do not go to the nature or existence of the economic loss or discount. Petitioner would determine the *existence* of discount by reference to the timing of its deduction. This is error.

To this end petitioner argues that original issue discount pertains only to the time cash money was originally received by the issuing corporation and not to the issuance of the bonds themselves. This clearly illustrates an erroneous preoccupation with the ***nature*** and ***timing*** of the consideration received for the bonds as indicative of discount and not the *value* of such consideration. Thus in his brief (p. 13) the Commissioner contends that "in order for bond discount to arise, there must be an obligation to make an outlay, in excess of the original capital borrowed". For purposes of this part of his argument he would treat the preferred stock acquired in exchange for the bonds as if it was indebtedness when issued and the later exchange of bonds merely a payer transaction having no independent significance. Then referring to other situations where there was no such obligation to repay and where discount *did not*, in fact, occur, he erroneously concludes therefrom that discount *cannot* ever occur even in situations where the obligation is to repay an amount much greater than that borrowed. For example, on page 14 of his brief one of the conclusions drawn is that bond discount cannot arise where one security is substituted for another, because the substitution constitutes a capital readjustment in which the issuer incurred no obligation to pay anything *"in excess of the amount borrowed because of the substitution of securities"* (emphasis supplied). Nowhere is the "amount borrowed" defined, yet based upon this analysis, petitioner requests a ruling that bond discount can ***never*** arise in a "capital readjustment". Presumably, petitioner would argue that the amount borrowed is always the amount to be repaid at maturity regardless of the facts. To him the actual "amount

borrowed" is not material or pertinent. The Treasury Regulations do not agree with this concept! Under this theory bond discount would never exist where one bond is issued in exchange for another even though a considerable discount was incurred when the original bonds were issued. Presumably, any such discount would be snuffed out by the later exchange in which the original bonds are replaced by the new bonds. Neither the landmark decisions of this Court nor the decisions of any lower courts support such a contention. See *Great Western Power Co.* v. *Commissioner*, 297 U.S. 543 (1936); *Missouri Pacific Railroad Co.* v. *United States*, 433 F.2d 1324 (Ct.Cl. 1970), modifying 427 F.2d 727 (Ct.Cl. 1970). It should be noted that in the *Missouri Pacific* case the Court of Claims upon reconsideration did *not* recede from its holding that bond discount could arise upon the exchange of new bonds for old bonds.

B. ***A recapitalization does not preclude the occurrence or deductibility of bond discount.***

Petitioner argues that the exchange of bonds for an existing issue of preferred stock cannot result in deductible bond discount for two reasons:

(1) the transaction is a recapitalization, and

(2) the recapitalization does not result in an obligation to pay more than the amount borrowed.

Amicus submits that it is not the law that a mere recapitalization itself precludes the existence of deductible bond discount. The cases are to the contrary. See, *American Smelting & Refining Co.* v. *United States*, 130 F.2d 883 (C.A.3rd 1942); *Industrial Development Corporation* v. *United States*, 51 A.F.T.R. 1514 (N.D. Ill. 1956); *Erie Lackawanna Railroad Co.* v. *United States, supra; Cities Service Company* v. *United States*, 316 F.Supp. 61 (S.D.N.Y. 1970); *Missouri Pacific Railroad Co.* v. *United States*, 433

F.2d 1324 (Ct.Cl. 1970); *Atchison, Topeka & Santa Fe Railroad Co.* v. *United States,* 443 F.2d 147 (C.A.10th 1971); *St. Louis-San Francisco Railway Co.* v. *United States, supra; Gulf Mobile and Ohio Railroad Co.* v. *United States,* 339 F.Supp. 489 (S.D.Ala. 1972). The real question is always the issue price of the bonds. If in a recapitalization the issue price is less than the amount to be repaid at maturity, deductible bond discount arises. The only possible exceptions would be tax-free transfers, exchanges or reorganizations under Sections 351 and 368 of the Internal Revenue Code, and then only if the bonds are exchanged for other bonds in equal principal amounts so that the exchange is entirely tax-free to the security holders and to the corporation. To contend that this is not so is fallacious. See Section 354, Internal Revenue Code.

Petitioner would make no distinction between preferred stock and bonds, on the grounds that they represent the same obligation of the corporation and the bonds are really a continuation of the preferred. Of course this is not true regardless of their alleged "highly equivalent characteristics". One is equity, the other is debt; and while they may appear to have an "arithmetical equivalence" insofar as a third party is concerned, to the issuing corporation and to investors they are radically different.

This argument regarding characteristics can very readily be applied in reverse. It would be just as logical to compare characteristics and to hold the preferred stock to have been bonds instead of holding the bonds to be in reality preferred stock (as petitioner suggests). In such case the deduction would clearly be appropriate. See, *Roberts & Porter, Inc.* v. *Commissioner,* 307 F.2d 745 (C.A. 7th 1962); *Missouri Pacific Railroad Co.* v. *United States,* 433 F.2d 1324 (Ct.Cl 1970). In fact, petitioner inconsistently argues at page 13 of his Brief that the preferred stock should be

treated as if it was debt when issued. It should also be noted parenthetically that while petitioner argues strongly that such "arithmetical equivalence" precludes the existence of bond discount stemming from a recapitalization, he chides the Tax Court and the Court of Claims for implying approval of a similar alleged "arithmetical equivalence" test as the proper method for ascertaining the existence of bond discount.

Nor does the asserted similarity of terms between the preferred stock and the debentures illustrate, as petitioner argues, a "fundamental legal principle". Their distinctiveness is decisive—one is equity, the other is debt. The cases and rulings cited by petitioner in support of his alleged "fundamental legal principle" contain one determinative factor not present in the case at bar and not in many similar cases, which makes the citations and the principle inappropriate—that factor is the issuance of common stock with the bonds or the issuance of the bonds to common stockholders who remain common stockholders. It is indisputable that if bonds and common stock are issued in exchange for securities, there can be no "issue price" for the bonds which is *less* than their principal amount, because any discrepancy in value or price must be deemed to be consideration for the common stock. The Treasury Regulations recognize this. Regulations, Section 1.1232-3(b)(2); Revenue Ruling 59-387, 1959-2 Cum.Bull. 56. Likewise, if bonds are issued as dividends to the common stockholders, no *exchange* takes place and there is no "issue price". But these situations and those in the cases cited by petitioner do not exist in the instant case. The failure of bond discount to arise in *some* instances does not preclude it from *ever* arising in *any* circumstance. See *Liquid Carbonic Corp.* v. *Commissioner*, 34 B.T.A. 1191 (1936), where stock was substituted for bonds.

In discussing the case of *Claussen's Inc.* v. *United States,* 469 F.2d 340 (C.A. 5th 1972), the petitioner admits that there the bonds were distributed to common stockholders, but seeks to distinguish this decisive difference by contending that the "critical fact" common to the instant case *and* to *Claussen's* is that the issuance of the debentures was not accompanied by the acquisition of any new capital (Petitioner's Brief, p. 17, footnote 16). This is not a true or legal distinction! In the case of *Great Western Power Co.* v. *Commissioner, supra,* this Court held to the contrary. The "recapitalization" there, which did not involve the acquisition of "new capital", did not preclude the existence of discount! There is no authority or reason for the proposition that discount cannot arise unless "new" cash capital has been acquired in the exchange. It would only be true in the circumstance where the bonds are distributed as a dividend to common stockholders, but it is absolutely untrue where the bonds are exchanged for other securities and the recipients thereof retain no continuing equity interest in the enterprise. In the latter circumstance, the former stockholder becomes a creditor, who eventually must be repaid the principal amount of the bond. See, *LeTulle* v. *Scofield* 308 U.S. 415 (1940).

Nor is it permissible to analogize the situation to one where the corporation instead of issuing bonds in exchange for the preferred stock retires or redeems the preferred with cash. In such case says petitioner, no tax deduction such as for bond discount may be claimed. The analogy is fallacious for these reasons:

(1) it assumes that the stock could be retired for a cash payment equal to the principal amount of the bonds that might be issued for the same purpose;

(2) it assumes that the corporation is financially able and willing to pay cash for the entire issue of stock, but instead chose to issue bonds, and

(3) it assumes a transaction that never occurred.

Inasmuch as in the case at bar the fair market value of the preferred stock was substantially lower than the principal amount of the bonds exchanged therefor, if the stock had been retired by a cash purchase in a market transaction it undoubtedly would have cost the corporation substantially less. Additionally, there is nothing apparent in the record to show that the corporation *could* have retired the stock for cash but instead chose to issue bonds in exchange therefor.

And finally, it should be noted that it is petitioner's own contention that transactions must be given their tax effect in accordance with what actually occurred rather than in accordance with what might have occurred. *Gregory* v. *Helvering*, 293 U.S. 465 (1935). Thus if petitioner is allowed to analogize the exchange of bonds for preferred stock to the *redemption* of the stock for cash, then respondent should be allowed to analogize the transaction to the sale of bonds at a discount for cash and the use of the cash to *purchase* the shares. See, Petitioner's Brief, pp. 26-28; *Television Industries, Inc.* v. *Commissioner*, 284 F.2d 322, 325 (C.A. 2nd 1960); *Commissioner* v. *Danielson*, 378 F.2d 771 (C.A. 3rd 1967). It is the transaction actually accomplished that the Court has to pass upon, not what might have been transacted, especially when the imputed or hypothetical transaction would have been radically different than what happened. This rule should apply to both parties. Petitioner should not be heard to complain of the same analogy which it seeks to apply; but if such analogy be invalid it is just as invalid as applied to petitioner as when applied by taxpayer.

C. *Whether bonds are issued for property or cash, or whether stock certificates are property, is irrelevant to the question of bond discount.*

Petitioner in his brief argues that a corporation's retirement of its own stock is not the acquisition of property which would give rise to bond discount, especially when the stock is cancelled upon its acquisition. Amicus submits that regardless of the merits of the argument (which petitioner admits was settled by the Congress in favor of taxpayers for years subsequent to 1969 by the Tax Reform Act of 1969) it is not relevant to the resolution of the question before the Court. As previously pointed out herein, the only question here is the "issue price" of the bonds. Whether they were issued for cash or property concerns the issue price only insofar as it entails a need for *valuation* where property is involved in the exchange. The confusion and alleged conflict in the court decisions in the past as to the existence of discount when bonds were issued for property was due primarily to the Commissioner's persistent, but erroneous, contention that discount could not arise where property was involved. See, *Nassau Lens Co. Inc.* v. *Commissioner,* 308 F.2d 39 (C.A. 2nd 1962); *Montana Power Co.* v. *United States,* 232 F.2d 541 (C.A. 3rd 1956). The original controversy has been resolved by the Congress but petitioner clings to the same old discredited concepts.

Faced with the rule annunciated repeatedly by the courts that discount may arise when bonds are exchanged for property, the Commissioner rebuts with the contention that preferred stock is not property. It should be observed that whatever the merits of the contention, it seems to be self-defeating for petitioner to contend that the acquisition of the preferred stock in exchange for the debentures did not constitute the acquisition of any property

or assets. If this argument is correct, unless there was a *gratis* distribution the issue price of the bonds under the applicable Treasury Regulations would be zero, and the entire principal amount must be amortized. Accordingly, the decision of the Court below that the fair market value of the preferred stock, i.e. $33 per share, constitutes the issue price of the bonds is clearly equitable and fair.

The truth is that the bonds were issued in *exchange* for the preferred stock and not as a distribution. It is contrary to the facts to allege, as does petitioner, that the corporation neither received nor realized anything upon the exchange. The preferred shares had value by reason of what they represented, not by reason of the certificates themselves. The corporation thus obtained the continued use of borrowed capital, which must be repaid in cash upon maturity of the bonds. It is specious and misleading to argue that the corporation receives nothing because the preferred share certificates are "not assets but only convenient machinery for evidencing shareholder interests" (Petitioner's Brief, p. 24). Obviously when the preferred certificates *evidencing* the shareholder interests are acquired the corporation retains the capital underlying the shares but upon the terms and conditions specified in the bonds. The terms of the acquisition are what is important. If it acquires such interest as a loan (which must be repaid), discount may arise. And fair market value is a reasonable measure of the amount of capital underlying the preferred shares which is borrowed when such shares are exchanged for the bonds.

The fallacy of the Commissioner's contention may be illustrated by assuming that the preferred shares were acquired by the corporation for a cash payment which, in turn, was reloaned to the corporation with the bond merely evidencing the indebtedness in a principal amount in excess

of the amount of cash borrowed. Clearly there would have been discount in such circumstances. The transaction which took place is no different in substance. A debt obligation was issued which must eventually be paid regardless of how much alleged "reshuffling" took place. To denominate a transaction as a "reshuffling" does not deprive it of its inherent economic significance and character. It is contrary to fact and patently erroneous to assume, as does petitioner, that the bonds were issued in a principal amount equal to the cash it might or would otherwise have paid to acquire the preferred stock (Petitioner's Brief, p. 32).

It is equally specious to contend that the substitution of one type of security (bonds) for another (stock) has no effect on the corporation other than a "reshuffling of a capital structure". It has the effect, as in the instant case, of obligating the corporation to repay borrowed capital that, until the exchange, it could have retained indefinitely.

Likewise, contrary to petitioner's implication, there is no dishonor accompanying the allowance of a tax deduction for interest where, theretofore, preferred dividend payments were not deductible. The obvious reason is that the corporation's obligations are not the same under each instrument—one is equity, the other is debt.

D. ***The court should not rule on the validity of matters or issues not before it.***

In reaching its decision in the instant case the Tax Court reviewed the law, adopted the criterion espoused by the Court of Claims for resolving the question, and held that taxpayer is not entitled to a deduction for debt discount. The criterion or theory espoused by the Court of Claims was that when a corporation acquires its own securities in exchange for its bonds, the issue price of the bonds is determined by reference to the amount orignally paid in to the

corporation for the old securities, with the immediate exchange being a mere paper transaction which finally resolves or consummates in the last issuance of debt. Petitioner, Commissioner of Internal Revenue, is applying such reasoning here in order to refute the respondent's discount deduction claim and is basing his arguments as to the exchange being a "recapitalization", "reshuffling", "substitution", etc. . . . squarely on the Court of Claims rationale and that of the Tax Court in this case. See, *Union Pacific Railroad Company* v. *United States,* 401 F.2d 778 (Ct.Cl. 1968); *Erie Lackawanna Railroad* v. *United States, supra; Missouri Pacific Railroad* v. *United States,* 427 F.2d 727 (Ct.Cl. 1970); *National Alfalfa Dehydrating and Milling Co.* v. *Commissioner,* 57 T.C. 46 (1971). See also, Petitioner's Brief, p. 28, footnote 26. Yet, at the same time that he is asking this Court to hold that no debt discount arose because of the application by the Tax Court of the proper criterion, he is asking it to turn around and reject the theory upon which such holding would be based, i.e., issue price must be determined by reference to the amount originally paid for the stock. Amicus submits that the "original consideration" theory, for which petitioner ultimately seeks rejection-in-advance, is not before the Court and its validity should be ruled upon only when properly and adequately presented in context. It should not be resolved without full consideration of all of the facts and circumstances. In substance, petitioner is seeking a declaratory judgment as to tax matters, which is prohibited by law. See, 28 U.S.C. Section 2201. Petitioner also seeks to induce the Court to decide other cases not now before it by referencing the facts in such cases as though they were matters of law. This it should not be allowed to do.

CONCLUSION

For the foregoing reasons the judgment of the Court of Appeals should be affirmed.

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December, 1973

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-9

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

—v.—

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY,

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-9

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

—v.—

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY,

Respondent.

BRIEF FOR AMICUS CURIAE

Question Presented for Review

Whether the issuance of a $50 face amount debenture in exchange for preferred stock of the issuer having a fair market value of $33 resulted in discount on the bond of $17, which is amortizable and deductible by the issuer for federal income tax purposes.

Statutes and Regulations Involved

Contrary to the statement of the government, section 1232 of the Internal Revenue Code of 1954 as amended by the Tax Reform Act of 1969, and section 1.163-3 of the Treasury Regulations as amended in 1968 are not applicable to this case since the case involves a taxable year ending

before these provisions were adopted. The pertinent provisions are section 163 of the Internal Revenue Code of 1954 and section 1.61-12 of the Treasury Regulations as it existed before the 1968 amendment.

Statement of Interest of Amicus Curiae

In July 1968, Norton Simon, Inc. ("Simon") issued $34,518,300 face amount of its six percent Sinking Fund Subordinated Debentures due July 1, 1998, in exchange for Preferred Stock of certain predecessor companies, *i.e.*, Hunt Foods and Industries, Inc. ("Hunt") and Canada Dry Corporation ("Canada Dry"). At the time of the exchange, the Preferred Stock had an aggregate fair market value of $27,066,460. The difference between the face amount of the Simon Debentures and the value of the Preferred Stock exchanged therefor was $7,451,840, and Simon treated this amount as discount on the Debentures, amortizing and deducting a ratable portion of the discount in following years.

These transactions were incident to a Plan of Consolidation, whereby Hunt, Canada Dry, and McCall Corporation were consolidated in July 1968 to form a new corporation, Norton Simon, Inc. The Internal Revenue Service ruled that the consolidation was basically a tax-free reorganization under Internal Revenue Code section 368(a)(1)(A), with exchanges pursuant thereto tax free; however, the exchanges of Hunt and Canada Dry Preferred Stock for Simon Debentures were held to be taxable transactions.

Simon's income tax return for its fiscal year ended June 30, 1969, has been audited by the Internal Revenue Service, and the Service has challenged the amortization and deduc-

tion of discount on the Debentures issued for the Preferred Stock. The matter is at present under administrative review in the Appellate Division of the Internal Revenue Service.

Simon has obtained the written consent of both petitioner and respondent in this case to Simon's filing this Brief for Amicus Curiae. These consents were filed with the Court at the same time this Brief was filed. Simon also filed an Amicus Brief in this case in the Court of Appeals for the Tenth Circuit below.

Statement of the Case

This case involves the review of a decision of the Court of Appeals for the Tenth Circuit in favor of National Alfalfa Dehydrating and Milling Company, the respondent (hereinafter the "taxpayer"), in a federal income tax controversy relating to the taxpayer's fiscal year ended April 30, 1967. Briefly, the taxpayer in July 1957 issued $2,352,950 face amount of five percent sinking fund debentures in exchange for 47,059 shares of its $50 par value preferred stock.[1] At the time of the exchange, the fair market value of the preferred stock was $33 per share, or $1,552,947 in aggregate. The difference between the face amount of the debentures and the fair market value of the preferred stock was $800,003. The taxpayer amortized and ratably deducted, as discount on the issuance of the debentures, portions of this amount in following years.

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[1] At the same time, the taxpayer issued $3 par value common stock in exchange for its outstanding $1 par value common stock, and issued to its preferred shareholders, in lieu of dividend arrearages on the preferred stock, warrants to purchase one-half share of common stock at a price of $10 per share on the basis of one warrant for each share of preferred.

On May 29, 1957, the National Office of the Internal Revenue Service issued a ruling on the taxpayer's proposed transactions, holding that gain or loss would be recognized to the preferred stockholders on the exchange of their preferred stock for the debentures, measured by the difference between the bases of the shareholders in their preferred stock and the fair market value of the bonds issued for the stock. The Internal Revenue Service relied on section 302(a) of the Internal Revenue Code as the basis for its ruling.[2]

On subsequent audit, the Commissioner disallowed the taxpayer's claimed deductions for amortization of discount. The Tax Court upheld the Commissioner's disallowance, but was reversed by the Court of Appeals for the Tenth Circuit, which held the taxpayer's deductions to be proper. See 472 F.2d 796 (10th Cir. 1973), *rev'g*, 57 T.C. 46 (1971).

Summary of the Argument

Where the face amount of a bond exceeds the amount or value received by the issuer for the bond, the excess constitutes discount. Like stated interest on a bond, discount constitutes a cost of borrowing. The issuer of a bond is entitled to amortize and deduct discount as an additional interest cost.

These principles should apply whether the issuer receives cash or some other valuable consideration in exchange for a bond. The cost of borrowing to the issuer is equally

[2] The Service also ruled that no gain or loss would be recognized on the exchange of $1 par value common stock for $3 par value common stock, under Internal Revenue Code sections 368(a)(1)(E) and 354(a).

real whether the corporation has borrowed cash or has incurred an obligation to make a deferred payment for a noncash consideration. For example, a corporation may issue a twenty-year bond with a face amount of $120 at an interest rate of five percent in exchange for $100 cash. The corporation may also issue the same kind of bond in exchange for its own preferred stock with a value of $100. In the taxpayer's view, these cases are economically equivalent. Discount is present in each case and is amortizable and deductible at the rate of $1 per year.

All courts which have considered the issue have held that discount may arise when a corporation issues a bond in order to acquire its own preferred stock. The courts have differed over the measure of such discount, but the better-reasoned view, adopted by the court below, is that discount is measured by reference to the fair market value of the stock at the time of the exchange. When a corporation incurs an obligation to make an outlay in excess of the value it has received, it is this excess, not any other amount, that represents the additional cost of borrowing to the issuer.

All parties to this case reject the view of some courts that discount on a bonds-for-stock exchange should be measured by the excess of the face amount of the bonds over the greater of the amount originally received *for the stock* or the "value of the stock to the corporation." This formulation combines two mutually inconsistent positions, each without merit. The term "value to the corporation" is meaningless in the tax laws unless it refers to fair market value, and the government concedes the concept to be unworkable. Pet. Br. 31. On the other hand, to determine the effective interest cost of issuing a bond for stock in a

current transaction by reference to the amount received for the stock years before in an unrelated transaction would ignore real discount on the current transaction.

Similarly, the government position that discount, a cost of borrowing or adjustment to the stated interest rate, cannot exist where a bond is issued in a nontaxable "recapitalization," or where one "security" is substituted for another, ignores both the nature of discount and the facts of this case. Discount, as a cost of borrowing, has economic reality without regard to the characterization of the borrowing transaction for other purposes. Moreover, the government's arguments have no application to this case since the taxpayer's bonds were issued, not in a nontaxable recapitalization exchange, but in a taxable repurchase of stock. The transaction in this case did not involve the substitution of one "security" for another. The taxpayer's stock was just that—stock, not a "security."

The government's ancillary arguments suffer from the same defects. Whether preferred stock constitutes "property" in the hands of its issuer for some specialized purpose, and whether what is received by a corporation on issuing a bond may be termed "capital," are matters having no relevance to the existence of a cost of borrowing incurred by the issuer to obtain the stock. To suggest that this Court's holding in the *Great Western Power Co.* case[3] is dispositive of this case involves a gross distortion of both this Court's opinion in the *Great Western* case and the facts of this case. To equate the issuance of a $50 bond for $50 cash with the issuance of a $50 bond for stock worth $33

[3] Great Western Power Co. v. Commissioner, 297 U.S. 543 (1936).

simply disregards the record and determined facts in this case.

Finally, Congressional enactments and the legislative history thereof demonstrate Congressional approval of the taxpayer's position and the holding of the court below. Statutory changes made by Congress in 1969 did not reflect any new views on the fundamental nature of discount, but were motivated by the practical policy considerations of discouraging the issuance of debt obligations in corporate reorganizations and providing for ease of administration. The 1969 statutory amendments were made effective prospectively only. The government would now have this Court reverse Congressional action by making the new rules applicable retroactively.

ARGUMENT

I.

The Taxpayer's Bonds Were Issued at a Discount to the Extent That the Face Amount of the Bonds Exceeded the Fair Market Value of the Preferred Stock at the Time of the Exchange.

A. *Discount on the issuance of a bond is amortizable and deductible by the issuer as interest expense.*

It is established beyond question that the excess of the face amount of a bond over the amount received therefor is discount, amortizable and deductible by the issuer of the obligation.[4] The reason for allowing the ratable deduction of discount is plain. Discount represents an expense of borrowing. It serves "the same function as stated interest,"[5] and "must be added to the aggregate coupon payments in order to arrive at the total interest paid."[6]

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[4] Helvering v. Union P.R.R., 293 U.S. 282 (1934); American Smelting & Ref. Co. v. United States, 130 F.2d 883, 885 (3d Cir. 1942). *See also,* H.R. REP. No. 91-413 (Pt. 1), 91st Cong., 1st Sess. 109 (1969), in which the Ways and Means Committee referred to the deduction of original issue discount as a "current interest deduction." The Treasury Regulations have long recognized the deductibility of discount. The Regulations in effect during the taxable year in issue, Regulations section 1.61-12(c)(3), T.D. 6272, 1957-2 CUM. BULL. 18, 32, stated in pertinent part: "If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds." Regulations section 1.61-12(c)(3) was amended in 1968 by T.D. 6984, 1969-1 CUM. BULL. 38, and the pertinent language was carried over in current Treasury Regulations section 1.163-3(a)(1).

[5] United States v. Midland-Ross Corp., 381 U.S. 54, 57 (1965).

[6] Helvering v. Union P.R.R., 293 U.S. 282, 286 (1934).

The government apparently does not contend to the contrary. See Pet. Br. 9-12. Therefore, the only issue in this case is whether there can be discount on the issuance of a bond for valuable consideration other than cash (here, preferred stock).

B. *There may be discount upon the issuance of a bond for property, including stock redeemed thereby.*

Nothing in the applicable statute[7] or the Treasury Regulations[8] suggests that discount may arise only upon the issuance of a bond for cash. Where the consideration received for the issuance of the bond has a measurable, ascertainable value, discount is equally real, and the tax results should be the same as in a cash situation. If the value of the consideration is less than the principal amount of the obligation, there is the same deferred interest cost, in addition to stated interest, as in the case of a bond-for-cash transaction. The majority of courts, including the court below, that have considered the question, have reached this conclusion.[9]

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[7] Int. Rev. Code of 1954, sec. 163. Hereinafter, all references to sections shall, unless otherwise indicated, be to sections of the Internal Revenue Code of 1954.

[8] During the years in issue, Treas. Regs. sec. 1.61-12(c)(3). Since 1968, the same language has been contained in Regulations section 1.163-3(a)(1). *See* note 4 *supra*.

[9] Indeed, the earliest authority supporting this view was a government ruling in O.D. 959, 4 CUM. BULL. 129 (1921), holding that the excess of face amount of mortgage bonds over the fair market value of liberty bonds received therefor represented amortizable discount. While O.D. 959 has been declared obsolete (without explanation) in Revenue Ruling 68-575, 1968-2 CUM. BULL. 603, 605, it was cited favorably as late as Revenue Ruling 57-535, 1957-2 CUM. BULL. 513.

In the case of *American Smelting & Refining Co.* v. *United States,* 130 F.2d 883 (3d Cir. 1942), the taxpayer issued its bonds in exchange for two issues of preferred stock of its subsidiary. With respect to one of the issues, the taxpayer established that the fair market value of the stock (determined by reference to trading on the New York Stock Exchange) was less than the face amount of the bonds, and the court held this difference to be amortizable discount. The government argued that discount could arise only where bonds are issued for cash on the ground that otherwise it would be impossible "to tell whether the loss which the amortization anticipates will ever occur." 130 F.2d at 885. The Court of Appeals, however, rejected this contention. The court first explained the basis for allowing the deduction:

> "It seems to us that the government's argument overlooks what we believe is the rationale of the theory underlying the amortized deduction of discount. Ordinarily, bonds are issued at a discount because the promised rate of interest is, due to the condition of the prevailing market, too low to sell them at par. It would, therefore, seem that the discount allowed is in the nature of additional interest which accrues over the life of the bond and is payable at the maturity of the principal obligation." *Id.*

The court then explained why the government's argument was incorrect:

> "We believe that the discount is still to be treated as additional interest when the subject matter of the loan is stock instead of cash. It is clear in both cases that the discount, or additional interest, is determined at the time the bonds are issued. Thus, when the investor is paid the face amount of the bond at maturity,

> he is taxable for the difference between that sum and the cost of the bond. Here the cost of the bond is the fair market value of the stock at the time the corporate obligations were exchanged. To sustain the government's contention, in view of these considerations, would be to say, in effect, that, on the same loan, the taxable 'interest' earned by the investor varies in amount and is computed as of a different time than the deductible 'interest' paid by the obligor. We think that this not only distorts, unnecessarily, the ordinary incidents of a commercial transaction but also upsets the balance of the tax situation." *Id.* (footnotes omitted).

The *American Smelting* decision was followed in two subsequent District Court cases (in the Fifth and Seventh Circuits, respectively), *Southern Fertilizer & Chemical Co.* v. *Edwards,* 167 F. Supp. 879 (M.D. Ga. 1955), and *Industrial Development Corp.* v. *United States,* 51 A.F.T.R. 1514, 56-2 U.S.T.C. ¶ 10,066 (D. Ill. 1956), both involving the issuance of bonds in exchange for the issuer's preferred stock. The Court of Appeals for the Third Circuit in *Montana Power Co.* v. *United States,* 232 F.2d 541 (3d Cir. 1956), *cert. denied,* 352 U.S. 843 (1956), subsequently reaffirmed its position in the *American Smelting* case.

In the case of *Nassau Lens Co.* v. *Commissioner,* 308 F.2d 39 (2d Cir. 1962), bonds were issued for the assets of a sole proprietorship. The Court of Appeals for the Second Circuit, in an opinion by Judge Marshall which agreed with the reasoning of *American Smelting,* held that amortizable discount could arise upon the issuance of bonds for property other than cash. The court found unpersuasive the argument that there was no discount because it could not be ascertained at the time the bonds were issued whether a subsequent sale of the assets would produce gain or loss:

> "It may well be true that to a 'borrowing buyer' interest or discount payments seem part of the cost of the property. In reality, however, they are the cost of using the money which is needed to purchase the property, a cost not incurred by the buyer with ready cash. . . . The contention asserted is merely that when a seller also becomes a financing medium by taking bonds issued at a discount instead of cash in exchange for property, the tax laws will not recognize a charge for the use of money. We find no support for such an assertion and reject it. See American Smelting & Ref. Co. v. United States, 130 F.2d 883 (3d Cir. 1942)." 308 F.2d at 44 (footnote omitted).

Discount in the case was determined to be the difference between the face amount of the bonds and the fair market value of the assets at the time of the exchange.[10]

The Court of Appeals for the Tenth Circuit, in the case of *Atchison T. & S.F.R.R.* v. *United States,* 443 F.2d 147 (10th Cir. 1971), reached the same conclusion as the courts in *American Smelting* and *Nassau Lens.* In the *Atchison* case, the taxpayer had issued bonds, in the course of a bankruptcy reorganization, for the bonds of its bankrupt predecessor. The court rejected the government's argument that no discount could arise on the issuance of bonds for consideration other than cash. The court found that the pertinent Treasury Regulations under the 1939 Code (which were identical to the Regulations governing this case) did not "distinguish between bonds issued for cash and bonds issued for property." 443 F.2d at 151. To the contrary, the court found that the Regulations recognized

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[10] The Second Circuit Court also decided that an alleged uncertain valuation of the property was "far too thin a reed" to support the Commissioner's contention. 308 F.2d at 44, n. 5.

"*sub silentio* the economic possibility that discount—that is, deferred interest—may be present when bonds are issued in exchange for property as well as for cash" and that such discount arises where "the stated rate of interest on the obligation is less than the rate demanded by the market." *Id.* The court reasoned that its view "conforms with economic and business reality which recognizes that to the issuer bond interest is reflected both by the stated rate of interest and by the amount below or above par received by the issuer when the bonds are originally distributed." *Id.* at 153.

In its opinion below in the present case, the Tenth Circuit Court reaffirmed its holding in the *Atchison* case that discount could exist where a bond was issued for a consideration other than cash, and, in particular, where a corporation issued bonds for its preferred stock. The court, correctly in our view, focused on the principle that discount represents a cost of borrowing, and correctly deemed irrelevant to the question of the cost of borrowing such factors as the character of the consideration or property received upon the issuance of the bond, whether the bonds were issued in a taxable or tax-free transaction, and, where the bonds were issued for preferred stock, the amount historically received by the corporation for the stock in a prior, unrelated transaction. None of these factors has any bearing on the effective interest rate the taxpayer was required to pay in order to acquire its preferred stock on a deferred payment basis.

No court has accepted the view here urged by the government—that there can be no discount when a corporation exchanges its bonds for its preferred stock. The cases discussed above are in agreement that there is discount to the extent that the face amount of bonds exceeds the fair mar-

ket value of the stock. The Court of Claims, certain District Courts, and the Tax Court below in the present case disagree with these decisions as to the measure of discount, but these courts agree that discount can arise upon the issuance of bonds for preferred stock.

C. *Where a corporation issues its bonds in exchange for its preferred stock, discount is measured by the excess of the face amount of the bonds over the fair market value of the stock.*

The Tax Court below held that there was no discount in this case, because it felt that discount should be measured by reference to the amount originally received years earlier by the corporation for the preferred stock. In effect, the Tax Court rejected the current fair market value approach adopted in the cases discussed above, in favor of a position adopted by the Court of Claims.[11]

While the government relied upon the Court of Claims decisions in the Tax Court below, the government's brief before this Court specifically rejects the reasoning of the Court of Claims in these cases. See Pet. Br. 9, 28-34. Even though the government no longer approves of the Court of Claims cases and its brief points out some deficiencies in the reasoning of the Court of Claims, an analysis of the Court of Claims decisions may help to illuminate the issue now before the Court.

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[11] Erie Lackawanna R.R. v. United States, 422 F.2d 425 (Ct. Cl. 1970); Missouri P.R.R. v. United States, 427 F.2d 727 (Ct. Cl. 1970), *modified*, 433 F.2d 1324 (Ct. Cl. 1970), *cert. denied*, 402 U.S. 944 (1971); St. Louis-S.F. Ry. v. United States, 444 F.2d 1102 (Ct. Cl. 1971), *cert. denied*, 404 U.S. 1017 (1972).

In its *Erie* decision,[12] and in its *Missouri Pacific* decision[13] prior to modification, the Court of Claims held that, where bonds are issued in exchange for preferred stock, discount is to be measured by the amount originally received by the corporation for its preferred stock, without reference to the fair market value of the stock acquired. In our view, this approach does not measure real discount. When a corporation issues bonds for its stock, it is the *current* value of the stock that determines the face amount and interest rate of bonds the issuer will issue and the stockholders will accept.

In the present case, the amount the taxpayer was obliged to pay to redeem its preferred stock and the effective interest rate required to defer payment were plainly unrelated to the amount received originally for the stock. The terms of the transaction would have been the same had the preferred stock been originally sold for $5 per share or $100 per share.

The issuing corporation could determine the precise rate of stated interest necessary to issue bonds with a face amount equal to the fair market value of the stock received. Alternatively, the issuer could, as in this case, choose to issue bonds with a face amount greater than the value of the stock but with a lower rate of interest. No one would suggest disallowing any portion of the deduction for stated interest in the first case; there is no more reason to disallow the amortization of discount in the second case. The cases are parallel and economically equivalent, differing in form only. Whether a stockholder had gain or loss on the

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[12] 422 F.2d 425 (Ct. Cl. 1970).

[13] 427 F.2d 727 (Ct. Cl. 1970).

exchange, or whether the corporation economically benefited from the issuance and later redemption of its stock, have nothing to do with the interest or discount expense involved in borrowing, *i.e.*, issuing bonds. Rather, in the making of a loan evidenced by bonds, "discount, or additional interest, is determined *at the time the bonds are issued.*" *American Smelting & Refining Co.* v. *United States,* 130 F.2d 883, 885 (3d Cir. 1942) (emphasis added).

The Court of Claims, in *Erie Lackawanna R.R.* v. *United States,* 422 F.2d 425 (Ct. Cl. 1970), lost sight of these realities in denying a deduction for discount in the following terms:

> "[S]ince plaintiff was exchanging $100 debentures for preferred stock for which it had already received $100 in value, then plaintiff lost nothing as a result of the transaction . . . . The fact that the preferred stock had a market value less than $100 at the time of the exchange is of no consequence in this type of transaction where the plaintiff is purchasing its own stock." 422 F.2d at 429 (footnote omitted).

In effect, the Court of Claims balanced a nontaxable benefit,[14] derived by the corporation from redeeming its preferred stock at less than par, against the discount on a borrowing transaction. We know of no authority, theory, or logic for this result. It would make fully as much

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[14] A corporation does not recognize gain or loss when it issues its own stock for money or otherwise. *See* sec. 1032. Nor does a corporation recognize gain or loss when it redeems its own stock, whether at a lower or higher price than the price at which the stock was issued originally and whether for cash or other property. *See* sec. 311; Treas. Regs. sec. 1.311-1(a). In the Tax Reform Act of 1969, section 311(d) was added to change the rule where a corporation distributes appreciated property in redemption of its stock. Section 311(d) does not apply here.

sense to disallow ordinary stated interest expenses, or indeed any ordinary and necessary business expenses of the corporation, until an offset of the corporation's nontaxable "gain" on repurchasing its preferred stock had been achieved.

The taxpayer in this case would not have been subject to tax if it had redeemed the preferred stock for cash, even though it would, in a sense, have had an economic benefit in the difference between the par value originally received for the preferred stock and the amount paid for the stock on redemption. The result is not different because the preferred stock was redeemed for bonds. The corporate benefit attributable to the stock would likewise in all events be nontaxable. A nontaxable gain in a capital stock transaction simply has nothing to do with the cost of borrowing.[15]

The error was seriously compounded when, shortly after the *Erie* decision, the Court of Claims modified its position in *Missouri P.R.R.* v. *United States,* 427 F.2d 727 (Ct. Cl. 1970), *modified,* 433 F.2d 1325 (Ct. Cl. 1970), *cert. denied,* 402 U.S. 944 (1971). In its original opinion in *Missouri Pacific* (427 F.2d 727), the court had adhered to

[15] The confusion engendered by the Court of Claims view is illustrated in the recent case of Gulf, M. & O.R.R. v. United States, 339 F. Supp. 489 (S.D. Ala. 1972), *supplemental opinion,* 31 A.F.T.R. 2d 73-434 (S.D. Ala. 1972), in which the court adopted the Court of Claims rule and gave as a rationale that a corporation in claiming discount on bonds issued for preferred stock "is attempting to make use of losses which have been borne by its shareholders in the marketplace, thus, in essence, utilizing the loss a second time." 339 F. Supp. at 497. This is an exceedingly strange argument. The gains or losses of shareholders on the exchanges of the stock, measured by their varying tax bases, have nothing whatever to do with the corporation's bond discount.

its holding in *Erie* that discount in a bond-for-stock exchange was measured by the excess, if any, of the face amount of the bonds over the amount originally received for the stock. Shortly thereafter, a District Court in New York,[16] dealing with the same issue, held that discount was to be measured by the excess of the face amount of the bonds over the *greater* of the amount originally received for the stock or "the actual value [of the stock] to the taxpayer."

Stating that it was persuaded by the opinion of the District Court, the Court of Claims modified its original *Missouri Pacific* opinion to adopt the *Cities Service* formulation of the measure of discount.[17] 433 F.2d at 1326. The inference is almost irresistible that the Court of Claims began to realize the troublesome implications of its original position. Under the *Erie* decision, a corporation that issued a $50 bond for a share of preferred stock originally issued for $10 per share, but worth $50 per share at the time of exchange, would be entitled to claim discount of $40 per bond although there was clearly no cost of borrowing other than the stated interest rate. In order to prevent such an unwarranted result, the Court of Claims simply combined its original rule with another, different rule.

To link the "value to the corporation" rule with the "original consideration" rule simply makes no sense; the

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[16] Cities Serv. Co. v. United States, 316 F. Supp. 61, 72 (S.D. N.Y. 1970), *supplemental opinions*, 330 F. Supp. 421 (S.D.N.Y. 1971), 362 F. Supp. 830 (S.D.N.Y. 1973), *gov't appeal to 2d Cir.*

[17] The Court of Claims adhered to this formulation in St. Louis-S.F. Ry. v. United States, 444 F.2d 1102 (Ct. Cl. 1971), *cert. denied*, 404 U.S. 1017 (1972).

two rules are inherently inconsistent. If discount is to be measured by reference to the historical amount received for the stock, then the "value of the stock to the corporation" is irrelevant; if discount is to be measured by reference to the "value of the stock to the corporation," then the historical amount received for the stock is irrelevant. Like the government, "we do not believe that either the issue price of stock or its 'value to the corporation' can contribute a valid measure for the determination of discount upon a recapitalization." Pet. Br. 31.

In its brief, the government makes a half-hearted effort to salvage at least the result that would be reached under the Court of Claims formulation, while rejecting the reasoning on which the result would be based. The government states that "as a matter of simple arithmetic" there can "be no discount when a corporation receives $50 and issues its obligations in the face amount of $50." Pet. Br. 28. Admittedly this is "simple arithmetic," but the statement ignores the patent fact that the taxpayer here did not receive $50 for its $50 bond, but rather received preferred stock worth $33. The $50 originally received for the preferred stock was received in a separate transaction—hardly a part of the repurchase of the stock years later. The receipt of the original $50 had nothing to do with the effective interest rate required to be paid in order to acquire stock worth $33. In short, the "simple arithmetic" applicable to this case is that when a corporation issues a $50 face amount bond and receives therefor consideration worth $33, the bond has been issued at a discount of $17. No amount of verbal juggling can alter this basic, stubborn fact.

It is clear that the government is not serious in its attempt to salvage the Court of Claims formulation because, after repeating its "$50 bond for $50" example of "simple arithmetic," the government asserts that somehow the arithmetic becomes less simple where a $55 bond is issued in exchange for stock for which the corporation had received $50 and that there would not be a discount of $5 in such a case. Pet. Br. 31. In short, the government is comfortable with the Court of Claims rule only as long as the rule produces a denial of discount, but repudiates the rule where it leads to unfavorable results for the government. While we agree with the government that the Court of Claims rule is basically incorrect, we urge that the rule be rejected across the board, not to be resurrected at the government's pleasure.

To summarize, the parties to this case concur that the Court of Claims rule is erroneous and should not be adopted by this Court. In determining discount where a bond is issued for preferred stock, it makes no sense to take into account the amount originally paid in *for the stock.* Bond discount is to be determined at the time the bonds are issued by reference to the value of what was received *for the bonds, i.e.,* the value of the stock. It is immaterial to the question of discount whether, because of other, unrelated tax rules, the issuing corporation has enjoyed a nontaxable economic benefit from the acquisition of its preferred stock.

II.

The Government's Position Consists of Novel Theories Having No Basis in the Statute or Regulations, No Judicial Sanction, and Neither Logic Nor Consistency.

In the judicial history of the issue before the Court, the government has at various times urged, without statutory or regulations basis, that there can be no discount on an exchange of bonds for property,[18] and that discount arises on a bond-for-stock exchange only if the amount originally received for the stock was less than face amount of the bonds.[19] These tenaciously argued, but erroneous, positions have now been abandoned by the government in the present case. In lieu thereof, the government urges that "recapitalization" principles and this Court's decision in the *Great Western Power Co.* case[20] compel a determination that the taxpayer did not issue its bonds at a discount. The present argument of the government is based essentially on redefining "discount," "securities," "obligations," and "recapitalization" to change the established meanings of those terms as they are used in the statute, regulations, and judicial decisions, and on a serious distortion and misapplication of the *Great Western Power Co.* decision of this Court.

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[18] *See, e.g.*, American Smelting & Ref. Co. v. United States, 130 F.2d 883 (3d Cir. 1942).

[19] *See, e.g.*, the opinion of the Tax Court below, 57 T.C. 46, 51 (1971).

[20] Great Western Power Co. v. Commissioner, 297 U. S. 543 (1936).

A. *The government misstates the nature of discount.*

The government attempts to redefine discount in a way that would preclude the existence of discount where bonds are issued in exchange for a corporation's own stock. Thus, the government repeatedly declares that discount can arise only in a transaction by which a corporation acquires "capital."[21] Clearly this is too narrow a concept of discount, advanced only in an attempt to support the government's "recapitalization" theory. Discount is a cost of borrowing generally and may arise whenever a corporation, for *valuable consideration,* incurs a debt. Where a corporation acquires its preferred stock in exchange for bonds payable in the future, it is acquiring something plainly of value in exchange for a promise to pay the purchase price in the future. It incurs a debt to former shareholders in consideration for receiving the stock. Compensation to the shareholders for the right to defer payment may consist of both stated interest and a promise to pay in the future an amount greater than the value of what the corporation received. The latter element is discount; it represents interest to the bondholder for the forbearance of money, and a cost to the bond issuer for the use of money. The cost is real, whether or not what the corporation receives can, for one purpose or another, be termed "capital."

The government argues that in order for discount to exist, "there must be an outlay, or an obligation to make an outlay, in excess of the amount of borrowed capital." Pet. Br. 7. It would be more accurate to say "in excess

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[21] *See, e.g.,* Pet. Br. 7, 14, 17; *cf. id.* at 23-24. In the government's view, a corporation's own stock does not constitute "capital."

of the amount or value received." The government then asserts that in this case "there was neither the requisite outlay nor the obligation" and that there was "no obligation to pay out more than the capital received." *Id.*; see also *id.* at 13-14.

It takes considerable temerity to declare that the taxpayer had no obligation. There is no suggestion in the record that the taxpayer's debentures were not validly issued or did not represent an enforceable claim against the taxpayer. The taxpayer received preferred stock worth $33 and incurred a fixed obligation to pay $50 in the future.

The government continues its misleading analysis by asserting further that the taxpayer "incurred no obligation to pay anything in excess of the amount borrowed." Pet. Br. 14. This assertion makes sense only if it is assumed that the taxpayer somehow "borrowed" $50 when it issued its bonds. In fact, the taxpayer simply received preferred stock worth $33, and the only amount "borrowed" was the amount needed to purchase the stock, *i.e.*, $33.

As authority for its strange analysis, the government cites the opinion of this Court in *Old Mission Portland Cement Co.* v. *Helvering*, 293 U.S. 289 (1934), holding that discount cannot be deducted on a consolidated return with respect to bonds of one member of the consolidated group held by another member of the group, since the anticipated payment of the bonds, upon which the discount deduction is based, would be an "intercompany transaction" not includible in the consolidated return. We fail to understand the relevance of this case. This Court's opinion did not remotely suggest that discount can exist only where a corporation acquires "capital." In fact, this Court stated

that discount arises because, at the maturity of the bonds, "the taxpayer pays the difference, between the amount realized upon the sale of the bonds and their par value." 293 U.S. at 292. In the instant case, the "amount realized upon the sale of the bonds" was $33 per bond, the fair market value of the preferred stock received by the taxpayer. Under the *Old Mission* case, the $17 difference between this amount and the $50 par value of the bonds represents discount.

B. *The government's contention that discount cannot arise where bonds are issued in a nontaxable recapitalization has no basis in authority or logic and is not in any event applicable to this case.*

The basic contention of the government appears to be a rather unfocused argument that no discount can arise with respect to debt obligations issued pursuant to a "recapitalization" described in section 368(a)(1)(E) of the Code. Pet. Br. 24. It is asserted that, since certain exchanges made pursuant to an "E" reorganization do not give rise to taxable *gain or loss* (see section 354), *discount* cannot exist when bonds are issued in an E reorganization, or, if it does exist, it cannot be deducted.

The reorganization provisions, however, do not deal in any way with the existence or deductibility of discount, which is a cost of borrowing and not gain or loss from the receipt or exchange of assets or property. The government appears to suggest, nevertheless, that nonrecognition somehow rubs off on the question of discount on bonds issued in a reorganization. This argument, based on a principle of "nonrecognition by association," not only has no merit, but also is not applicable to this case, where the Internal

Revenue Service has ruled that the bonds were issued in a *taxable* transaction.

Although the issuance of bonds in exchange for preferred stock may in some circumstances arguably constitute a recapitalization within the meaning of section 368(a)(1)(E), it is quite clear that since 1954 this transaction is treated as a redemption of stock under section 302,[22] not as a non-taxable reorganization exchange. In consequence, the shareholder recognizes gain or loss to the extent of the difference between his basis in the stock given up and the fair market value of the bonds received. Example 3 of section 1.354-1(d) of the Treasury Regulations provides:

> "C, a shareholder in Corporation Z (which is not a railroad corporation), surrenders all his stock in Corporation Z in exchange for securities in Corporation Z. Whether or not this exchange is in connection with a recapitalization under section 368(a)(1)(E), section 354 does not apply. See, however, section 302."[23]

The Internal Revenue Service ruling to the taxpayer in this case (reproduced in the opinion of the Tax Court below, 57 T.C. at 48, n. 3) conformed to this Regulation.

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[22] *I.e.*, assuming no dividend equivalence, the acquisition of the stock is treated "as a distribution in part or full payment in exchange for the stock." Sec. 302(a)

[23] Section 354 cannot apply to such an exchange because the section does not apply where securities are received and no securities are surrendered. Sec. 354(a)(2)(B). It is significant that prior to the enactment of this provision in 1954, the government had consistently taken the position in litigation that the issuance of bonds for stock constituted a (taxable) redemption rather than a (nontaxable) recapitalization. *See, e.g.*, Alan O. Hickok, 32 T.C. 80 (1959), *nonacq.*, 1959-2 CUM. BULL. 8; Wolf Envelope Co., 17 T.C. 471 (1951), *nonacq.*, 1952-1 CUM. BULL. 6; Clarence J. Schoo, 47 B.T.A. 459 (1942), *nonacq.*, 1942-2 CUM. BULL. 31.

The ruling stated that, assuming the bonds qualified as bona fide debt obligations, gain or loss would be recognized to the preferred shareholders under section 302(a).[24] Consequently, there was nothing tax-free about the issuance of the taxpayer's bonds that could "rub off" on the issue of discount.

Even in a tax-free situation, the government's recapitalization theory is unsound. Since discount represents simply a cost of borrowing, it may exist whenever there is a borrowing regardless of the nature of the transaction in which the borrowing occurs. There is no reason to treat discount differently from stated interest on a corporate bond; stated interest is deductible by the corporation re-

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[24] The government's brief ignores the ruling received by the taxpayer except for one reference in a footnote. Pet. Br. 16, n. 14. The government there asserts that, because the ruling held that the preferred shareholders had capital gain or loss from the receipt of the debentures, "the ruling necessarily indicated that no discount resulted to the corporation since discount to the corporation would have produced equivalent ordinary income to the recipients of the debentures." This statement is misleading in several ways. First, the ruling was issued on May 29, 1957, at a time when section 1232 provided that original issue discount would not constitute taxable income to the holder of a bond until the sale or exchange of the bond. It is not surprising, therefore, that the ruling did not purport to deal with future tax results from the sale or exchange of the bonds that might take place in later years. The government could equally argue that the stated interest paid on the bonds is not deductible by the taxpayer since the ruling did not state that such interest would be income to the bondholders.

Second, the ruling in no way negatived discount. It stated that the shareholders would recognize gain or loss based on the fair market value of the debentures received and that the basis of the debentures to the shareholders would be that fair market value. Any excess of the face amount of the bonds over the basis of the bonds (fair market value at the time of the exchange) would, of course, constitute original issue discount. *See* sec. 1232(b), as it existed in 1957. The assertion in the footnote, therefore, is erroneous.

gardless of whether the bond is issued in a recapitalization or in any other transaction, taxable or nontaxable.[25]

This view has been reflected in virtually every decision to consider the question of discount on bonds issued other than for cash, even though the courts have differed on other aspects of discount. Thus, the Court of Claims, in its initial opinion in *Missouri Pacific R.R.* v. *United States*, 427 F.2d 727 (Ct. Cl. 1970), reviewed what meager authority it could find on the effect of a reorganization on discount,[26] and concluded:

> "Despite this authority, which is not exactly overwhelming in its strength or particularly persuasive in its approach, we find that bond discount can arise where there is a difference between what is given up and what is received, and this can occur in connection with a corporate reorganization." 427 F.2d at 733.

Other courts that have adopted the Court of Claims approach in the case of bonds issued for stock have also failed to find any significance in whether or not the bonds

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[25] *Cf.* Treas. Regs. secs. 1.483-1(b)(1) and (6) Ex. (7), where for the purpose of determining interest on deferred payments under Code section 483, the government has made it clear that there may be an unstated interest factor in a reorganization exchange. *See also*, Regs. sec. 1.483-1(b)(6), Ex. (4), providing that there may be unstated interest on the redemption of stock through the issuance of an obligation.

[26] The only authority the court could find was Revenue Ruling 59-387, 1959-2 CUM. BULL. 56, certain dictum concurred in by only two of the seven judges of the Third Circuit in Montana Power Co. v. United States, 232 F.2d 541 (3d Cir. 1956), *cert. denied*, 352 U.S. 842 (1956), and an old Board of Tax Appeals opinion in New York, C. & St. L. R.R., 23 B.T.A. 177 (1931), *aff'd*, 64 F.2d 152 (D.C. Cir. 1933). Examination of these two court opinions does not reveal any real support for the government's theory.

were issued in a tax-free transaction. See *Gulf M.&O. R.R.* v. *United States,* 339 F. Supp. 489 (S.D. Ala. 1972), *supplemental opinion,* 31 A.F.T.R.2d 73-434 (S.D. Ala. 1972); *Cities Service Co.* v. *United States,* 316 F. Supp. 61 (S.D.N.Y. 1970), *supplemental opinions,* 330 F. Supp. 421 (S.D.N.Y. 1971), 362 F. Supp. 830 (S.D.N.Y. 1973), *gov't appeal to 2d Cir.*

In *Industrial Development Corp.* v. *United States,* 51 A.F.T.R. 1514, 56-2 U.S.T.C. ¶ 10,066 (D. Ill. 1956), the court found that amortizable discount was created upon the issuance of debentures for preferred stock in a transaction the Internal Revenue Service had ruled to be a tax-free recapitalization:

> "The fact that the debentures were issued in connection with a tax-free recapitalization resulting in the recognition of no gain or loss to the recipient of the debentures, does not deprive the Plaintiff of its right to amortize and deduct the discount over the life of the debentures." 51 A.F.T.R. at 1518, 56-2 U.S.T.C. at 56,804.

See also *Southern Fertilizer & Chemical Co.* v. *Edwards,* 167 F. Supp. 879 (M.D. Ga. 1955), where the court reached the same conclusion in the case of bonds issued for preferred stock in a recapitalization. Similarly, the court in *Nassau Lens Co.* v. *Commissioner,* 308 F.2d 39 (2d Cir. 1962), found that there was discount in the issuance of bonds for tangible assets in a tax-free exchange under section 351.

In short, many courts have considered the question of discount on bonds issued in tax-free reorganizations, but

no court, as far as we are aware, has based its conclusion on whether the bonds were issued in a taxable or tax-free transaction. The government, however, continues to urge its recapitalization argument without statutory or judicial authority, in a case where the transaction was not tax-free.

The only hint, at best, of support for the government's position is contained in its own pronouncement in Revenue Ruling 59-387, 1959-2 CUM. BULL. 56. A careful reading of this Revenue Ruling reveals that even it fails to assist the government. The ruling dealt with a corporation that had issued bonds and common stock for its outstanding preferred stock, and held that the excess of the aggregate *fair market values* of the bonds and common stock over the fair market value of the preferred stock did not constitute discount. The taxpayer here does not contend that discount is computed by reference to the fair market value of the bonds issued but rather that the relevant measure is the *face amount* of the bonds. Since discount is premised on the obligation of the issuer to pay an amount greater than the value of what it received, and since the obligation of the issuer is to pay the face amount of the bonds, it is the excess of the face amount, not the fair market value of the bonds, over the value received that constitutes the measure of discount. Revenue Ruling 59-387 simply disapproves of a discount theory which is not advocated by any party in this case and which does not appear to have been advocated in any other reported case.

C. *The government's reliance upon cases involving exchanges of securities is misplaced; these cases do not deal with the existence and measure of discount, and the present case does not involve an exchange of securities.*

The government repeatedly characterizes this case as one in which the taxpayer substituted one issue of "securities" for another issue of "securities", and repeatedly asserts that the substitution of one security for another cannot produce deductible bond discount. See Pet. Br. 8, 9, 14, 16, 24, 27, 29. As with its statements that discount cannot arise in a "recapitalization" and that discount can arise only where a corporation acquires "new capital," the government appears to believe that sheer repetition of the statement "the substitution of securities cannot produce discount" will dispense with the need for analysis.

The term "securities" in the tax laws is, like the term "recapitalization," a specifically defined term which is not used in some vague generic sense. In the cases cited by the government and in Subchapter C of the Code generally dealing with the taxation of corporate transactions, the term "security" refers to a debt obligation issued by a corporation, and does not apply to an equity or proprietary interest such as preferred stock. See, *e.g.*, Code secs. 354 and 356, which refer to "principal amount" of "securities,"[27] as distinguished from "stock."

The instant case involves bonds (*i.e.*, debt obligations to pay fixed sums at a future date) issued in redemption of preferred stock. Preferred stock cannot be considered a "security" within the context of authorities cited by the

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[27] *See also*, Rev. Rul. 59-98, 1959-1 CUM. BULL. 76; Griswold, *"Securities" and "Continuity of Interest,"* 58 HARV. L. REV. 705 (1945).

government. Consequently, it is seriously misleading to refer to this case as one involving the substitution of one issue of securities for another.

The government goes to some length in an attempt to show that the taxpayer's bonds were virtually identical to its preferred stock (Pet. Br. 14-15), stating that the exchange of bonds for preferred stock "had no major investment significance either to [the taxpayer] or to its preferred shareholders." It may be true that from a broad economic and investment point of view the distinction between corporate debt obligations and preferred stock may sometimes be less important than their similarities. However, the distinction between debt and stock can hardly be ignored in a court of law and is particularly important in the tax laws.[28] The test is not one of "investment signifi-

[28] Some of the more important tax consequences of the distinction may be noted: Interest paid on debt is deductible (Code sec. 163), while dividends paid are generally not. Interest received by a bondholder is fully taxable as ordinary income (Code sec. 61 (a)(4)), while distributions received by a stockholder may not be under some circumstances (Code secs. 301(c), 316). Dividends up to $100 received by an individual are excluded from gross income (Code sec. 116), while there is no such exclusion for interest. Intercorporate dividends result in a deduction for the recipient (Code sec. 243), while there is no such deduction for the recipient of intercorporate interest. The treatment of the holder of a worthless debt obligation may differ from that of the holder of worthless stock. Compare Code secs. 165(g) and 166. Gain on the retirement of a debt obligation may be treated differently from gain on the redemption of stock. Compare Code secs. 302 and 1232. The distinction is crucial in the "continuity of interest" test devised by this Court in the case of corporate reorganizations. *See* LeTulle v. Scofield, 308 U.S. 415 (1940). Section 385 of the Code, added by section 415(a) of the Tax Reform Act of 1969, empowers the Treasury to promulgate "such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated for purposes of this title as stock or indebtedness." Sec. 385(a). For an exhaustive study of the topic, *see* Plumb, *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX L. REV. 369 (1971).

cance." There have been literally hundreds of cases in which the courts have had to determine whether a particular interest in a corporation represented a stock interest or a true debt obligation for tax purposes.[29]

The government's attempt to demonstrate the similarity between the taxpayer's bonds and its preferred stock, and the contention that, to the extent an exchange took place, it benefited the corporation (Pet. Br. 14-15),[30] are simply irrelevant to this case. There is no contention by the government that the taxpayer's bonds did not constitute valid debt obligations or that they should be treated as an

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[29] *See, e.g.*, this Court's opinion in John Kelley Co. v. Commissioner, 326 U.S. 521 (1946). *See also* the cases cited in Plumb, *supra* note 28.

[30] It is interesting to compare the government's analysis with that of the District Court in Gulf M.&O. R.R. v. United States, 339 F. Supp. 489, 497 (S.D. Ala. 1972), involving an exchange similar to the one here in question:

> "This court is convinced that an exchange of a corporation's income debentures for its outstanding preferred stock is more than a 'mere reshuffling of assets.' Instead, a very basic transformation has occurred in the capital structure of the corporation. A creditor, with full rights, has been substituted for what had previously been one with owner interest in the company. An obligation to pay the face amount of the debentures plus the interest rate has been created from what once was a discretionary power depending only upon earnings and the good faith of management. Also, from the corporation's standpoint, a deductible yearly expense has been substituted for non-deductible dividend payments."

The government goes far afield in suggesting that the existence of discount, a cost of borrowing, is determined by an analysis of whether the borrowing transaction as a whole produced a benefit or burden to the issuer or its bondholders. Presumably, every corporate borrowing is undertaken with the object of producing some type of benefit, but surely such intent has nothing to do with the measure of the effective interest rate of the borrowing or the deductibility of discount.

equity interest for tax purposes; conversely, there is no contention by the government that the taxpayer's preferred stock should be treated as debt for tax purposes.[31] Regardless of broad economic similarities, the bonds and the preferred stock must be treated for tax purposes as distinct types of legal interests, and the issuance of the bonds in exchange for the preferred stock cannot be regarded as the substitution of one issue of securities for another (*i.e.*, the substitution of one issue of debt obligation for another).[32]

The government also relies on the recent case of *Claussen's, Inc.* v. *United States*, 469 F.2d 340 (5th Cir. 1972), as authority for its "substitution of securities" argument. Pet. Br. 16-17. The *Claussen's* case, however, dealt with a situation altogether different from this case. The taxpayer in *Claussen's* issued to its common shareholders, on a pro rata basis, bonds and new common stock, so that after the exchange the shareholders retained the same proportionate proprietary interests in the corporation they had prior to the exchange. In addition, they received bonds. The Court of Appeals held that no discount was created in this transaction since the shareholders gave up nothing of value which the corporation received for the issuance of

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[31] *See, e.g.*, the government's arguments in Ragland Inv. Co., 52 T.C. 867 (1969), *aff'd per curiam*, 435 F.2d 118 (6th Cir. 1970); Zilkha & Sons, Inc., 52 T.C. 607 (1969), *acq.*, 1970-1 CUM. BULL. xvi.

[32] Otherwise, the ruling of the Internal Revenue Service in this case—that the exchange of bonds for stock was taxable—which has not been challenged by any party, would be seriously questionable. *Cf.* Commissioner v. Neustadt's Trust, 131 F.2d 528 (2d Cir. 1942); Rev. Rul. 58-546, 1958-2 CUM. BULL. 143.

the bonds; in short, there was no borrowing upon which discount could arise. 469 F.2d at 344.[23]

Unlike the transaction in the *Claussen's* case, the taxpayer's preferred shareholders here did not retain the stock interests they exchanged and, therefore, did not retain a ratable equity interest in the company. Where a corporation redeems preferred stock that is not held ratably to common stock, the preferred stockholders are exchanging something of value; a cost of borrowing may be incurred in the form of discount if the corporation, in exchange for the stock, promises to pay in the future an amount of money greater than the value of the stock.

The government invokes this Court's decision in *Great Western Power Co.* v. *Commissioner,* 297 U.S. 543 (1936), declaring that the *Great Western* case is "directly contrary" to the decision of the court below (Pet. Br. 8), and that the court below improperly "disregarded" the *Great Western* decision (Pet. Br. 27). The government further characterizes the *Great Western* case as holding that "for purposes of determining the existence and amount of discount upon the substitution or exchange of one issue of securities

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[23] The court stated, "In other words bond discount might properly be incurred, in economic terms, in a transaction involving some form of borrowing by the corporation at a cost to it of something more than the coupon rate of interest, or conversely in the situation where something of real value to the corporation is surrendered in exchange for its new bonds. . . . Immediately after recapitalization the original shareholders owned substantially the same equity interest in the corporation as they had held before and thus their prior rights of ownership were preserved intact. This being so, the old shareholders surrendered nothing of value to the corporation [citation omitted], and as a consequence there was no 'borrowing' sufficient to give rise to bond discount." *Id.* (footnotes omitted).

for another, the transaction must be viewed as a continuum." *Id.* Aside from the fact that the present case, as discussed above, does not involve the substitution of one issue of securities for another, the government's description of the holding of *Great Western* is pure distortion.

If the *Great Western* case held what the government claims it does, it might be expected that the case would have played a major role in the numerous decisions discussed above involving the questions of the existence and measure of discount on bonds issued for bonds or stock. A review of the cases involving this issue, however, reveals that *Great Western* has never been cited, much less relied upon, by any court. Indeed, the government's brief before the Tax Court in this case failed to cite the *Great Western* case, and the government's brief before the Court of Appeals in this case referred to the *Great Western* case simply as a "related decision." Only now has the *Great Western* case become a "contrary" decision.

The *Great Western* case has received no attention in the decisions of the courts considering the present issue because that case has no bearing on the issue. In the *Great Western* case, the taxpayer issued at a discount certain bonds under an indenture providing that the holders had the option, if the taxpayer called the bonds, to elect to receive new bonds equal in face amount to the old bonds, plus an amount of cash, in lieu of receiving the face amount of the old bonds. The taxpayer called the old bonds, and some bondholders elected to receive new bonds plus cash. The taxpayer attempted to use the issuance of the new bonds pursuant to this option as an occasion for deducting unamortized discount on the old bonds. This Court denied

the deduction. The decision holds that, where the holder of a bond exercises his option to substitute a new bond for the old and where the bonds are of equal face value, the issuance of the new bonds is not to be considered as a payment of the old bonds that would permit the deduction of unamortized discount on the old bonds; the unamortized discount on the old bonds must instead be amortized over the life of the new bonds.

The *Great Western* case did not present the question whether discount arose on the substitution of the new bonds and cash for the old bonds. There is nothing in this Court's opinion or in the opinions of the lower courts[34] in *Great Western* to indicate the fair market value of the old bonds, and there is no indication that such fair market value was less than the face amount of the new bonds plus the cash received by the bondholders. The *Great Western* case dealt with the proper treatment of discount created on the original issue of old bonds that were later replaced by new bonds; in the present case, new bonds were exchanged for outstanding preferred stock, upon whose issuance, of course, no discount arose or could have arisen.

The court below concluded that the tax consequences in this case, where bonds were issued for preferred stock, should be the same as in a case where a corporation issues bonds at a discount for cash and uses the cash to redeem preferred stock. The government argues that an analysis based on "such a division of [the taxpayer's] unified transaction into the suggested non-existent hypothetical components" is improper, citing *Great Western*. Pet. Br. 26.

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[34] 79 F.2d 94 (2d Cir. 1935), *rev'g*, 30 B.T.A. 503 (1934).

In this statement, the government misconceives the import of the reasoning of the court below. The court below did not indicate that the transaction in the instant case should be broken down into two transactions for tax purposes, but simply stated that the tax consequences of the actual transaction here involved (the issuance of bonds for preferred stock) were the same consequences that would result if bonds were issued at a discount for cash and the cash used to redeem preferred stock.

This Court held in the *Great Western* case that the conversion of one bond according to its terms into another bond of equal face amount did not produce the same tax consequences that would have resulted from issuing new bonds for cash and using the cash to retire the old bonds. In substituting one bond for another the corporation had not made the outlay upon which the deduction of unamortized discount is premised. In the present case the taxpayer, by issuing a $50 bond for stock worth $33, incurred the same obligation to make an outlay in excess of the value of what it received that it would have incurred had it issued the $50 bond for $33 cash.

D. *The government's equation of the transaction in this case with a redemption of the preferred stock for $50 cash is contrary to the record.*

After declaring that it is improper to restructure the transaction, the government offers its own analysis based on comparing different transactions. It asserts that, since the taxpayer would have incurred no discount expense if it had redeemed its shares for $50 cash per share, the substitution of a $50 bond cannot produce a deduction for discount. Pet. Br. 7, 18-19, 32-34.

To support this conclusion, the government hints that the issuance of the taxpayer's bonds for its preferred stock was accomplished pursuant to the redemption provisions applicable to the preferred stock, pointing to provisions in the taxpayer's certificate of incorporation and the preferred stock certificates giving the taxpayer the power after December 1, 1955, to redeem the preferred shares at a price of $51 per share as long as there were no dividend arrearages. Pet. Br. 18. The actual transaction in this case, of course, was not undertaken pursuant to these redemption provisions, but was undertaken pursuant to a new plan that required the approval of the taxpayer's shareholders.[35]

The government correctly observes that a corporation recognizes no gain or loss when it redeems its own shares for cash. See sec. 311. The government then asks, in light of this fact, how discount can arise where stock is redeemed for a bond. As the government is well aware, the discount claimed by the taxpayer in this case is based on the issuance of the taxpayer's obligation to pay an amount greater than that received by the taxpayer for the issuance of the obligation; the taxpayer's claim is not that it suffered a loss by acquiring its preferred stock. Consequently, the cases and Code sections cited by the government (Pet. Br. 18) are wholly irrelevant.

The government's analogy of the issuance of a $50 bond to a $50 cash payment may be intended to suggest that the taxpayer's preferred stock had a fair market value of $50

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[35] A similar attempt to recast the facts of the case was made by the government, and rejected by the court, in Cities Serv. Co. v. United States, 316 F. Supp. 61, 66-69 (S.D.N.Y. 1970).

per share at the time of the exchange. If so, the suggestion is entirely unsupported by anything in the record. Rather, the court below reached its conclusions upon the basis that the taxpayer's preferred stock was worth $33 per share. See, 472 F.2d at 797, 800, 801, 802, 804. The government did not apply to this Court for *certiorari* on the ground that the preferred stock was worth more than $33 per share, and assuredly the writ was not granted by the Court to review the valuation of the preferred stock.

E. *Whether the taxpayer's preferred stock constituted "property" in some specialized technical sense has no relevance to the issue presented in this case; the stock was valuable consideration received by the taxpayer for its bonds.*

The government asserts that a corporation's repurchase of its own preferred stock does not constitute the acquisition of an "asset," and that such preferred stock in the hands of the corporation is not considered "property" for certain tax purposes. Pet. Br. 8, 23-26. From this, the government concludes that cases involving the exchange of bonds for "property" are not here relevant. Although intimating that the preferred stock is a kind of nullity, the government would doubtless admit that in the hands of the shareholders the preferred stock did constitute "property," so that it is not entirely accurate to describe the issuance of bonds for preferred stock as the issuance of bonds for some form of nothing or "non-property."

We need not pursue these niceties since questions of the existence and measure of discount in the instant case do not depend upon whether the taxpayer's preferred stock constituted "property" in a special sense for special

purposes.[36] What is significant is that the corporation received for its bonds valuable consideration of a value less than the face amount of the bonds. This case is not like the *Claussen's* case, where bonds were simply distributed pro rata to shareholders. The taxpayer did not issue bonds to its preferred shareholders as a dividend or as a gift. The taxpayer obtained stock worth $33 a share in the over-the-counter market in exchange for its promise to pay $50 in the future. The $17 difference represents a cost of borrowing—a cost that was real and that was incurred irrespective of any label which may be applied to the consideration received by the taxpayer.

The defects in the government's "property" argument are the same as the defects in its "capital," "recapitalization," and "substitution of securities" arguments and may be seen readily in a simple illustration. Suppose a corporation wishes to acquire two items, a depreciable asset and a block of its own preferred stock, each with a market value of $1,000. Suppose further that the corporation finances its purchases by borrowing and issuing bonds. This borrowing may take either of two forms: the corporation may give its one-year bond bearing nine percent interest with a face amount of $2,000, or it may give its one-year bond bearing four percent interest with a face amount of approximately $2,100. In the latter case, the amount of $100 is clearly discount, an added cost of borrowing. This is so regardless of the nature of the assets acquired with the $2,000 proceeds.

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[36] Under Code section 317(a), to which the government refers (Pet. Br. 24), the term "property" does not include stock in the distributing corporation for purposes of the sections of the Code dealing with corporate distributions on stock (sections 301-317). This special definition has no application to any provision of the Code relating to interest or discount. *Cf.* sec. 1232(b)(2).

The result should be the same if the acquisitions are financed through the sellers of the property. To illustrate, the corporation could give the seller of the depreciable asset its one-year bond bearing nine percent interest with a face amount of $1,000, or its one-year bond bearing four percent interest with a face amount of approximately $1,050. Clearly, in the latter case, there would be discount of $50. Similarly, the corporation could give the seller of the preferred stock either of the two bonds. In the case of the four percent $1,050 bond, there would be discount of $50; the existence and measure of this discount would in no way be affected by whether the preferred stock were considered "property" or an "asset," by whether the transaction were considered to be the acquisition of new "capital," or by whether the transaction were considered to be a "recapitalization" or the "substitution of one security for another." Yet the government in effect argues that, although the two four percent bonds, one issued to the seller of the depreciable asset and the other to the seller of the preferred stock, are in all respects identical, discount would exist only with respect to the bond given to the seller of the depreciable asset. Such a conclusion is wholly illogical and, we believe, insupportable.

In short, where a corporation issues its bonds for valuable consideration, it is in effect borrowing an amount equal to the fair market value of what it receives. If it binds itself to pay back in the future more than it receives at issuance, there is discount on the bond. This is the economic reality.

III.

The Decision of the Court Below Is Also Supported by the Amendments to Section 1232(b)(2) of the Code Made by the Tax Reform Act of 1969.

Up to this point, we have considered what the courts have said about bond discount, and analyzed the logic and implications of the government's arguments. We believe it also worthwhile to examine the enactments and stated purposes of the Congress in this area.

In the Tax Reform Act of 1969, Congress amended section 1232 of the Code, dealing with the treatment of original issue discount by bondholders. The primary purpose and effect of the amendments was to achieve consistency in treatment between issuers and holders in the reporting of discount: holders were required to report discount income ratably, just as issuers had always ratably amortized discount expense.

The 1969 changes arose at the instance of the Treasury, which made the following proposal:

> "Present concern is also expressed about transactions in which debt is a significant element of the acquisition price. Tax policy should focus on the appropriateness of the interest deduction with respect to the issued debt. It appears, however, that the greatly increased use of debt in recent acquisitions is motivated primarily by factors other than the desire to obtain an interest deduction for tax purposes. . . .
>
> . . . .
>
> ". . . [W]e propose that the following immediate steps be taken by legislative action. These steps will

impede mergers and acquisitions in which debt securities are used to gain tax advantages . . . .

. . . .

"(2) To achieve consistency of treatment between bondholders and the issuing company where bonds are issued at a discount, we recommend that Section 1232 be amended to require that original issue discount be treated as additional interest income to the bondholders to be reported ratably over the life of the bonds." REPRESENTATIVES OF THE TREASURY DEPARTMENT, TAX REFORM PROPOSALS CONTAINED IN THE MESSAGE FROM THE PRESIDENT OF APRIL 21, 1969, PRESENTED TO THE COMM. ON WAYS AND MEANS, 91st Cong., 1st Sess. 47-49 (Comm. Print 1969).

The Treasury recognized that a corporation could amortize and deduct discount with respect to bonds issued in tax-free reorganizations for stock or other assets. The Treasury did not propose to alter that treatment. It only proposed that the bondholders' treatment be made consistent.

The Ways and Means Committee in turn expressed concern about the conglomerate problem and its relation to debt-financed acquisitions:

"There are also provisions of the tax laws which your committee believes provide an inducement to the use of debt in corporate acquisitions and, accordingly, act as a stimulant, generally, to merger activity. These provisions include . . . (3) *the rules governing original issue discount which permit the interest element to be ratably deducted by the acquiring corporation, but which is not ratably reported, by the debenture owner.*" H.R. REP. No. 91-413 (Pt. 1), 91st Cong., 1st Sess. 103 (1969) (emphasis added).

Thus, the Ways and Means Committee recognized, as did the Treasury, that the issuing corporation could amortize

and deduct original issue discount in a merger acquisition (*i.e.*, a tax-free reorganization). The Committee was not disturbed by the corporation's deduction, but was concerned with the failure of the debenture-owner ratably to report discount income.

As passed by the House and as reported by the Senate Finance Committee, section 413 of the Act contained the following addition to section 1232(b)(2) of the Code:

> "In the case of a bond or other evidence of indebtedness, or an investment unit as described in this paragraph, issued for property, the issue price of such bond or other evidence of indebtedness or investment unit, as the case may be, shall be the fair market value of such property."

This provision, of course, expressed the rule of the *American Smelting, Nassau Lens,* and *Atchison* cases—that discount could arise from the issuance of bonds for property, and that the measure of discount was the fair market value of the property received.

In explaining this provision, the House Ways and Means Committee observed:

> "There is some question under present law as to whether the original issue discount rule applies to a bond which is issued for property, *such as stock,* which has a value below the face amount of the bond.
>
> . . . .
>
> "In order to *clarify* the situations in which original issue discount may arise, the bill further provides that there may be original issue discount when a corporation issues a bond for a price less than its face value whether it receives cash, *stock,* or other property (including the assets of another corporation) for the

bond." H.R. REP. No. 91-413 (Pt. 1), 91st Cong., 1st Sess. 109-110 (1969) (emphasis added).

The clarification presumably intended was to provide expressly what the Treasury and the Ways and Means Committee assumed was the sound existing law—that the issuing corporation could deduct and amortize bond discount on bonds issued for property, including stock, and to make the debenture holder's treatment of original issue discount consistent.[37]

The Senate Finance Committee approved the House proposal to clarify the situation in which original issue discount may arise when bonds or evidence of indebtedness are issued for property. S. REP. No. 91-522, 91st Cong., 1st Sess. 146-148 (1969). The Staff of the Joint Congressional Committee noted that "[t]he bill also clarifies present law by providing that original issue discount may arise when a bond is issued in exchange for stock or other property." STAFFS OF JOINT COMM. ON INTERNAL REVENUE TAXATION & COMM. OF FINANCE, 91st Cong., 1st Sess., SUMMARY OF H.R. 13270, THE TAX REFORM ACT OF 1969 (AS PASSED BY THE HOUSE OF REPRESENTATIVES) 61 (Comm. Print 1969).[38]

At the last-minute suggestion of the Treasury, the bill was thereafter modified on the floor of the Senate in two

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[37] A clarification of existing law by a Committee report is entitled to great respect. *Cf.* Commissioner v. Bilder, 369 U.S. 499 (1962).

[38] In the case of Missouri P.R.R. v. United States, 427 F.2d 727 (Ct. Cl. 1970), the Court of Claims dismissed (at 731, n. 7) the significance of this legislative history as not "detrimental" to its decision. Obviously, however, the Treasury, Congressional, and Staff actions and statements are completely inconsistent with the Court of Claims view.

respects: (1) the issue price determined on the basis of the fair market value of the property was limited to situations where either the bonds are traded on an established securities market or the property consists of securities so traded; (2) the definition of issue price was revised so that, in the case of a bond or evidence of indebtedness issued pursuant to a plan of reorganization, the issue price is deemed to be the stated redemption price at maturity.

These changes were explained in a letter from John S. Nolan, Deputy Assistant Secretary of the Treasury, to Senator Williams. Mr. Nolan stated that the first limitation was to prevent a whip-saw effect for the Treasury, which could occur if the bond issuer and the bondholder valued the property transferred to the corporation differently. This could not arise if the values were determined on an established securities exchange. Mr. Nolan explained the new exclusion for reorganization exchanges as follows:

> "The reorganization problem arises because in a tax-free reorganization, no gain or loss is recognized to the corporations involved and the basis of the assets of the transferor corporation carries over, that is, such assets have the same basis in the hands of the transferee corporation. Under these circumstances, original issue discount should not be taken into account so as to give the transferee corporation an amortization deduction as a result of the issuance of its bonds in the reorganization. In other situations, the issuing corporation pays a price where there is original issue discount because the basis of the assets is their lower value at the time the bonds are issued rather than the face amount of the bonds. In a reorganization, however, where the basis of the assets carries over, this 'leveling' factor does not exist and there is every reason for the issuing corporation to claim a low value for the assets to

increase its amortization deduction for bond discount if such a deduction is allowed." 115 CONG. REC. 36730 (1969).[39]

In any event, the changes suggested by the Treasury and made on the floor of the Senate were applicable prospectively only, to bonds or evidence of indebtedness issued after May 27, 1969. They did not retroactively change what the Congressional Committees and the Treasury viewed as the proper pre-existing law.

In essence, the government's argument to this Court urges the Court to pronounce retroactively a new rule that Congress has made prospective only from the middle of 1969 on. The new Congressional rule was not represented to be a restatement of prior law; Congress regarded the prior law as determined by the various Courts of Appeals, including the Court of Appeals below, to be sound. Congress merely responded to a last-minute Treasury appeal, on limited practical policy grounds, to change the law for the future. The 1969 legislation and legislative history thus strongly support the decision of the court below.

[39] The Treasury saw problems in bonds issued to acquire assets because of valuation uncertainties where depreciable assets are the consideration. These problems do not exist in any form in the case now before this Court. In the instant case, the preferred stock had a readily ascertainable value by virtue of being traded over the counter.

CONCLUSION

For the reasons stated above, the judgment of the Court of Appeals should be affirmed.

Respectfully submitted,

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In the Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-9

COMMISSIONER OF INTERNAL REVENUE,
PETITIONER

v.

NATIONAL ALFALFA DEHYDRTING AND
MILLING COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

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1. The only issue in this case is whether respondent was entitled to claim deductions for amortizable bond discount upon its issuance of $50 face amount 5 percent debentures in substitution for its eliminated $50 par 5 percent preferred stock. Nevertheless, both respondent (Br. 18-22) and *Amicus* Norton Simon, Inc. (Br. 24-29) have interjected into that issue irrelevant discussions of the tax treatment of respondent's shareholders. In so doing, each misstates the Commissioner's position as dependent upon the reorganization provisions of Sections 368 and 354 of the Code. These two sections, however, are nowhere mentioned in our opening brief and are unrelated to our argument.

In their discussion of the irrelevant tax consequences to respondent's shareholders, both respondent (Br. 20) and *Amicus* Norton Simon, Inc. (Br. 24-26) make much of the Internal Revenue Service ruling issued in advance of the transaction. There, the Commissioner ruled (R. 17-21) that respondent's common shareholders who exchanged $1 par common stock for $3 par common stock would recognize no gain or loss. He further ruled that holders of the eliminated preferred shares who received respondent's debentures would recognize capital gain or loss measured by the difference between the fair market value of the debentures and their cost bases in their preferred shares. The correctness of that ruling is not questioned by either party in this case. Moreover, its conclusions have no bearing on the question whether respondent is entitled to deductions for amortizable discount.

The tax consequences of a transaction involving corporate shares upon the shareholders are rarely reflected in any complementary tax effect upon the corporation issuing the shares. Thus, for example, had the preferred shareholders received cash upon elimination of their preferred shares they would have been required to recognize gain or loss upon the transaction but there would have been no gain or loss to the corporation. Cf. Section 311(a) of the Code. Had the preferred shares had a market value of $50 upon their elimination, the position of respondent and the *amicus* would require them to acknowledge that no discount arose upon the issuance of the debentures. The preferred shareholders would still be required to recognize gain or loss, the amount of which would depend upon their bases in the preferred shares. Thus, the tax consequences of the transaction to the preferred shareholders considered in the Commissioner's ruling have no bearing upon the existence of discount.

One parallel, however, between the discount question and its ultimate effect upon the debenture holders deserves mention. Under Section 1232(a)(1) and 1232(a)(2)(B), the $17 discount per debenture claimed by respondent would, if it existed, give rise to an equivalent amount of ordinary income to the debenture holders upon the sale or retirement of the debentures. If over one-third of the $50 face amount of the debentures were taxable at ordinary income rates under such circumstances, the debenture holders would, to say the least, find such tax treatment surprising. Indeed, the possibility of this tax consequence was nowhere mentioned in the proxy statement (R. 173-181) describing the transaction which both classes of respondent's shareholders approved.

2. Apart from the fact that the tax consequences to the shareholders discussed in the Commissioner's ruling are irrelevant, respondent and *Amicus* Norton Simon, Inc., have both erroneously stated the Commissioner's position is based upon a claim that the transaction at issue was a tax-free reorganization under Sections 368(a)(1)(E) and 354. This assertion is without foundation. Although we have characterized the elimination of respondent's preferred stock and the issuance of debentures in substitution therefor as a "recapitalization," we have nowhere suggested that the transaction would qualify as a Section 368(a)(1)(E) reorganization or that such qualification is a necessary element in our argument. To the contrary, we have employed the term "recapitalization" in its general sense in order to point out that the effect of the transaction was simply a modification of respondent's capital structure. Indeed, respondent's own directors characterized the transaction as "a reorganization of the Company by way of recapitalization" (R. 56).

In order to clarify the confusion generated by respondent and *Amicus* Norton Simon, Inc., we note that the question in this case has no connection with Sections 368(a)(1)(E) or 354. Those provisions govern the tax treatment of shareholders and not of the corporation whose stock or securities may be exchanged.[1] With respect to the tax consequences to the shareholders, the decisions under the 1939 Code consistently held that a similar exchange of a corporation's preferred shares for its bonds was a transaction in which neither gain nor loss was reorganized to the preferred shareholders participating in the exchange.[2] However, in 1954, Congress codified and somewhat expanded this Court's decision in *Bazley* v. *Commissioner,* 331 U.S. 737, and thereby changed the results of these decisions.[3] Under Sections 354(a)(2) and 356(a) and (d) of the 1954 Code, shareholders involved in such exchanges must recognize gain or loss. It was on the basis of those provisions, new in the 1954 Code, that the Commissioner ruled that respondent's preferred shareholders would recognize gain or loss upon receipt of the debentures.

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[1] The tax consequences of a recapitalization to the corporation being recapitalized is in no way affected by Section 368(a)(1)(E). Wholly apart from the applicability of the tax-free reorganization provisions, a recapitalization does not generally produce gain or loss to the corporation because its mechanics do not involve any taxable event. Cf. *Commissioner* v. *Capento Securities Corp.,* 140 F. 2d 382 (C.A. 1).

[2] Cf., *e.g., Hickok* v. *Commissioner,* 32 T.C. 80; *Wolf Envelope Co.* v. *Commissioner,* 17 T.C. 471; *Schoo* v. *Commissioner,* 47 B.T.A. 459.

[3] S. Rep. No. 1622, 83d Cong., 2d Sess., pp. 265, 268-269.

3. Finally, *Amicus* Norton Simon, Inc. (Br. 42-47) seeks support for its position from the legislative history of Section 413(b) of the Tax Reform Act of 1969, 83 Stat. 487, amending Section 1232(b)(2) of the Code with respect to bonds issued after May 27, 1969. It recognizes that if the amended version of Section 1232 (b)(2) were applicable to this case, respondent's claim to discount would be foreclosed. From this fact the *amicus* negatively infers that the government "[i]n essence" urges a retroactive application of the new legislation (Br. 47). The 1969 legislative history, however, offers no support for a claim of discount in this pre-1969 transaction.[4]

The House Ways and Means Committee, presumably referring to the existing conflict of decisions,[5] stated in its Report[6] as follows:

> There is some question under present law as to whether the original issue discount rule applies to a bond which is issued for property, such as stock, which has a value below the face amount of the bond.

The House Bill, applicable to bonds subsequently issued, would have resolved the uncertainty by enacting, in general terms, the rule of the *American Smelting* decision.[7] The Senate Finance Committee concurred.[8] But that was not the end of the matter. In the Senate, a different and contrasting resolution of the uncertain-

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[4] See our opening brief, p. 23, n. 25.

[5] See our opening brief, pp. 21-22.

[6] H. Rep. No. 91-413 (Part 1), 91st Cong., 1st Sess., p. 109.

[7] *Id.*, p. 110.

[8] S. Rep. No. 91-552, 91st Cong., 2d Sess., p. 148.

ty was adopted. The Senate largely rejected the *American Smelting* rule and enacted the rule of the Court of Claims in its *Montana Power* and *Southern Natural Gas* decisions,[9] excepting only cases where the bonds issued were traded on an established securities market or the property acquired was stock or securities traded on an established securities market.[10] The Conference Committee accepted the Senate version,[11] and the bill was enacted in that form. Consequently, with the exceptions noted, Section 1232(b)(2) now provides, with respect to bonds issued after May 27, 1969:

> Except in cases to which the preceding sentence applies, the issue price of a bond or other evidence of indebtedness (whether or not issued as a part of an investment unit) which is issued for property (other than money) shall be the stated redemption price at maturity.

Hence, the general rule of the amendment is that no discount shall arise upon the issuance of bonds for property. This represents in effect a congressional rejection of the *American Smelting* decision. The *amicus* cannot infer that Congress approved the *American Smelting* rule for years prior to 1969 simply by characterizing the Senate changes to Section 1232(b)(2) as having been made in response (Br. 47) "to a last-minute Treasury appeal, on limited practical policy grounds * * *."

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[9] See our opening brief, p. 21.

[10] Neither respondent's preferred stock nor its debentures were traded on an established securities market.

[11] H. Conf. Rep. No. 91-782, 91st Cong., 2d Sess., pp. 135-136, 307-308.

Thus, from the legislative history, it appears that:

(1) Section 1232(b)(2), as amended, is applicable only with respect to bonds issued after May 27, 1969. For that reason it is inapplicable to the debentures issued by respondent. Congress did not purport to resolve the uncertainties concerning bonds issued prior to the effective date of the amendment.

(2) Insofar as the congressional resolution may be deemed significant as a guide to the resolution of questions with respect to obligations issued prior to May 27, 1969, it rejected, with limited exceptions inapplicable here, the rule of the *American Smelting* case for which respondent and the *amicus* supporting it contend.

The legislative history of the Tax Reform Act of 1969, therefore, offers no support to the position of respondent and *amicus*. We do not assert that the 1969 legislation adds, in any direct fashion, strength to the Commissioner's position with respect to the pre-1969 debentures issued here. However, it is beyond question that the congressional resolution applicable to obligations issued after May 27, 1969, is, for the most part, parallel to the Commissioner's position in this case.

Respectfully submitted.

ROBERT H. BORK,
Solicitor General.

JANUARY 1974.

DOJ-1974-01

COMMISSIONER OF INTERNAL REVENUE *v.* NATIONAL ALFALFA DEHYDRATING & MILLING CO.

CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

No. 73-9. Argued January 14, 1974—Decided May 28, 1974

Respondent corporate taxpayer, pursuant to a recapitalization plan, issued $50 face value 5% sinking fund debentures in exchange for its outstanding unlisted $50 par 5% cumulative preferred shares, which at the time were quoted at approximately $33 per share on the over-the-counter market. Based on the exchange, respondent claimed on its income tax returns for several years deductions for debt discount under § 163 (a) of the Internal Revenue Code of 1954, which allows deductions for interest paid on indebtedness. Respondent asserted that the debt discount, measured by the difference between a claimed $33 per share value for the preferred, and the face amount of the debentures, amortized over the life of the debentures, constituted deductible interest within the purview of that provision. The Commissioner disallowed the deductions, and was upheld by the Tax Court, but the Court of Appeals reversed. *Held:* Respondent did not incur amortizable debt discount upon the issuance of its debentures in exchange for its outstanding preferred stock. Pp. 142–155.

(a) In determining whether debt discount arises in the situation presented here, the relevant inquiry must be whether the corporate taxpayer has incurred, as a result of the transaction, some cost or expense of acquiring the use of capital. P. 147.

(b) The propriety of a deduction does not turn upon general equitable considerations, such as a demonstration of effective economic and practical equivalence to what actually occurred, but rather "depends upon legislative grace; and only as there is clear provision therefor can any particular deduction be allowed." Pp. 147–149.

(c) This Court will not speculate as to what the market price and the investor reaction to any sales of the debentures or purchases of the preferred by respondent in the open market would have been, since there is nothing in the record to establish the cash price at which the debentures could have been sold upon the

market or to indicate that respondent would have been able to purchase all its outstanding preferred on the open market, or at what price that stock would have been purchased in light of the impending exchange; moreover, when a corporation issues to its preferred shareholders its own new debt obligations in exchange for the outstanding preferred, the claimed fair market value of both securities is somewhat artificial since the exchange is effectively insulated from market forces. Pp. 149–151.

(d) Absent any evidence that the difference between the claimed $33 per share of the preferred and the face amount of the debentures is attributable to debt discount or that the discount rate was determined by such factors as respondent's financial condition at the time of the exchange and the availability and cost of capital in the general market as well as from the preferred shareholders, rather than simply having been predicated on the preferred's par value, the requisite evaluation of the property to be exchanged cannot occur and debt discount cannot be determined. P. 151.

(e) The alteration in the form of the retained capital did not give rise to any cost of borrowing to respondent, since the cost of the capital invested in respondent was the same whether represented by the preferred or by the debentures, and was totally unaffected by the market value of the preferred received in exchange. Pp. 151–155.

472 F. 2d 796, reversed.

BLACKMUN, J., delivered the opinion of the Court, in which BURGER, C. J., and DOUGLAS, BRENNAN, WHITE, MARSHALL, POWELL, and REHNQUIST, JJ., joined, and in Parts I, II, and III of which STEWART, J., joined. STEWART, J., concurred in the judgment.

Stuart A. Smith argued the cause for petitioner. With him on the brief were *Solicitor General Bork, Assistant Attorney General Crampton, Meyer Rothwacks,* and *Ernest J. Brown.*

Charles White Hess argued the cause for respondent. With him on the brief was *Ronald B. Stang.**

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*Briefs of *amici curiae* urging affirmance were filed by *Thomas E. Tyre* for Cities Service Co.; by *Robert T. Molloy, James Ogden, Mark M. Hennelly, Donald E. Engle, George E. Bailey, Robert E.*

MR. JUSTICE BLACKMUN delivered the opinion of the Court.

A corporate taxpayer in 1957 issued $50 face value 5% sinking fund debentures in exchange for its outstanding $50 par 5% cumulative preferred shares. At the time, the preferred apparently had a fair market value of less than $50 per share. This case presents the question whether, under § 163 (a) of the Internal Revenue Code of 1954, 26 U. S. C. § 163 (a),[1] the taxpayer is entitled to an income tax deduction for amortizable debt discount claimed to be the difference between the face amount of the debentures and the preferred's value at the time of the exchange.

I

The facts are stipulated. The respondent, National Alfalfa Dehydrating and Milling Company (hereinafter called "NAD" or the "taxpayer"), is a Delaware corporation organized in May 1946. It has its principal office at Shawnee Mission, Kansas. It is engaged in the business of dehydrating and milling alfalfa.

At its organization, NAD was authorized to issue $50 par cumulative preferred shares and $1 par common shares. The preferred was entitled to preferential dividends at the rate of 5% per annum and was redeemable, in whole or in part, at the discretion of the board of directors or through the operation of a sinking fund, at a stated, variable price which, in 1957, was $51 per share plus

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Simpson, and *James L. Boring* for St. Louis San Francisco Railway Co. et al.; by *Alan D. Berlin*, *Walter J. Rockler*, and *Julius M. Greisman* for Norton Simon, Inc.; and by *Paul A. Peterson* for Fed-Mart Corp.

[1] "§ 163. Interest.

"(a) General rule.

"There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness."

accrued dividends. The sinking fund provision required that 20% of net earnings (after the payment of the preferred's dividends) was to be set aside and employed for the redemption of preferred. Any shares so redeemed were to be retired and could not be reissued. If there was a dividend arrearage, the preferred could not be purchased, redeemed, or otherwise acquired for value by the corporation unless the holders of 50% of the preferred shares consented, or unless NAD notified all preferred shareholders of its desire to purchase and invited tender offers. Upon voluntary liquidation, the preferred was entitled to $50 per share plus accrued dividends before any distribution was made to holders of the common shares.

Prior to July 23, 1957, NAD had outstanding common shares and 47,059 preferred shares on which there were dividend arrearages of $10 per share. The preferred outstanding thus had an aggregate par value of $2,352,950 as of that date.

On April 8, 1957, NAD's board of directors adopted resolutions[2] "to effectuate a reorganization of the Company by way of recapitalization." App. 56. The plan proposed by the board had three steps: (1) an amendment of NAD's articles of incorporation to eliminate the preferred as of August 1, 1957, to increase the par value of the common from $1 to $3 and the number of shares of common authorized from 763,000 to 1,000,000, and to authorize the issue of warrants for the purchase of common shares; (2) the indentured issuance of $2,352,950 principal amount of 18-year 5% sinking fund debentures due July 1, 1975, with one $50 debenture to be exchanged for each share of outstanding $50 preferred; and (3) the issuance, to the holder of each share of preferred, of a

[2] The resolutions are set forth in full in the opinion of the Court of Appeals. 472 F. 2d 796, 798 n. 1 (CA10 1973).

warrant to purchase one-half share of common at $10 per share in lieu of the $10 dividend arrearage. The members of the board would have testified that the "principal business purpose behind the 1957 exchange of debentures for the preferred stock was to enable National Alfalfa to expand its eastern producing areas." *Id.*, at 25.

After the board had taken this action, NAD and Fidelity-Philadelphia Trust Company, as trustee, executed a trust indenture dated July 1, 1957, pursuant to which the aforementioned debentures were to be issued in exchange for NAD's outstanding preferred.[3]

Fidelity-Philadelphia Trust Company, on behalf of NAD, requested a ruling from the United States Treasury Department as to the federal income tax consequences of the plan. A responsive letter-ruling over the signature of the Chief, Reorganization and Dividend Branch, was forthcoming on May 29, 1957. The request had sought a ruling that all aspects of the plan would be tax free. The ruling, however, was to the effect that the exchange of the $1 par common for $3 par common "will

[3] The indenture provided for subordination, redemption, and a sinking fund. Specifically, the debentures were to be subordinate to bank loans for inventory purposes and to obligations for materials, services, and labor supplied in the normal course of business. They were redeemable, in whole or in part, and from time to time, after July 1, 1958, at par plus accrued interest.

The sinking fund provision required NAD, after April 30, 1959, to set aside annually, for redemption of debentures at par plus accrued interest, the lesser of (a) the sum sufficient to redeem $196,080 face amount of debentures, or (b) the consolidated net earnings for the fiscal year, with the proviso that if the latter became applicable for any year, the fixed figure was to be cumulative.

NAD has not been in default in the performance of these indenture obligations. As of April 30, 1967, only $581,300 of the original $2,352,950 of debentures remained outstanding. The rest had been redeemed or otherwise repurchased or retired. App. 29.

constitute a recapitalization and, therefore, a reorganization, within the meaning of section 368 (a)(1)(E), of the Internal Revenue Code of 1954," 26 U. S. C. § 368 (a)(1)(E), and that, as a result thereof, under § 354 (a) of the Code, 26 U. S. C. § 354 (a), no gain or loss would be recognized on that exchange by NAD or by its common shareholders. App. 20. The ruling went on to state, "Assuming but not determining that the 5% debenture bonds to be issued qualify as securities (create a genuine relationship of debtor and creditor), gain or loss will be recognized to the preferred stockholders [under § 302 (a) of the Code, 26 U. S. C. § 302 (a)] from the exchange" of the preferred and the dividend arrearage for the debentures and warrants. The gain or loss so to be recognized would be "measured by the difference between the cost or other adjusted basis of the preferred stock surrendered and the fair market values of the debentures and warrants received." App. 20–21.

Shareholder approval of the plan proposed by the board was forthcoming in due course. Accordingly, NAD's articles were amended; on July 23, 1957, the holder of each share of preferred received, in exchange therefor, a $50 face value 5% debenture due July 1, 1975, and a warrant to subscribe to a half share of common at $10 per share in lieu of the dividend arrearage; and the preferred was eliminated and canceled as of August 1. This was reflected on NAD's books by a debit to the preferred stock account for $2,352,950, thereby eliminating that account, and by a credit to the liability account for the 18-year 5% debentures in the aggregate amount of $2,352,950.

NAD's preferred shares were not listed. During the period from July 15–30, 1957, the bid quotation for the preferred on the over-the-counter market ranged from a low of 29 to a high of 33, and the offering quotation

ranged from a low of 32 to a high of 35. App. 161.[4] On July 23, when the exchange was effected, the mid-point between the bid and offering quotations on the over-the-counter market was 33. The National Stock Summary for October 1, 1957, showed 100 shares of NAD preferred wanted on July 9 at 32 and on July 10 at 33, and 100 shares offered on July 10 at 35. *Id.*, at 167. It showed no quotations for the warrants in July and only nominal figure want quotations for them on four dates in August. *Id.*, at 168.

On each of its federal income tax returns for the fiscal years ended April 30, 1958, to 1967, inclusive, NAD claimed a deduction under § 163 (a) for what it regarded as interest, by reason of debt discount, measured by the difference between $33 per share for the preferred on July 23, 1957, and the face amount of the debentures. This difference amounted to $800,003 ($2,352,950 for the debentures, less $1,552,947 for the preferred). The $800,003 was then amortized on a straight-line basis over the 18-year life of the debentures, with an addition each year for the unamortized discount on any debentures currently repurchased or redeemed. See Rev. Rul. 70–353, 1970–2 Cum. Bull. 39. The deductions claimed are set forth in the margin;[5] those of the earlier years were reflected in losses carried over to fiscal 1967.

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[4]

Date	Bid	Offer	Date	Bid	Offer
July 15	33	35	July 23	32	34
July 16	32	35	July 24	32	35
July 17	32	34	July 25	29	32
July 18	31	34	July 26	30	33
July 19	32	34	July 29	30	33
July 22	31	33	July 30	30	33

[5] The deductions for discount taken by NAD on its returns for its fiscal year 1958 through 1967 were:

[*Footnote 5 is continued on p. 141*]

Upon audit of NAD's return for fiscal 1967, the Commissioner of Internal Revenue disallowed the debt discount of $109,804 claimed for that year and $321,657 in loss carryovers from prior taxable years that were due to debt-discount deductions asserted in those years. This resulted in a substantial deficiency in NAD's 1967 corporate income tax.

On petition for redetermination, the Tax Court, by a unanimous reviewed opinion, upheld the Commissioner. 57 T. C. 46 (1971). Adopting the reasoning of the Court of Claims in *Erie Lackawanna R. Co.* v. *United States*, 190 Ct. Cl. 682, 422 F. 2d 425 (1970), and in *Missouri Pacific R. Co.* v. *United States*, 192 Ct. Cl. 318, 427 F. 2d 727 (1970), modified on rehearing, 193 Ct. Cl. 257, 433 F. 2d 1324 (1970), cert. denied, 402 U. S. 944 (1971), the Tax Court held that when a corporation issues obligations in exchange for its outstanding preferred, no discount arises if the amount that had been received upon the issuance of the preferred was equal to

Year Ended	Unamortized Discount On Bonds Currently Repurchased or Redeemed	Straight-line Amortization	Total
4/30/58	—0—	$37,037	$37,037
4/30/59	$20,104	43,273	63,377
4/30/60	17,007	42,310	59,317
4/30/61	—0—	28,743	28,743
4/30/62	14,062	27,751	41,813
4/30/63	—0—	27,751	27,751
4/30/64	26,624	25,562	52,186
4/30/65	37,903	22,168	60,071
4/30/66	4,139	21,761	25,900
4/30/67	98,824	10,980	109,804
			$505,999

the face amount of the obligations issued upon the exchange. The market value of the preferred at the time of the exchange, therefore, would be of no relevance.

On appeal, the United States Court of Appeals for the Tenth Circuit, by a divided vote, reversed. 472 F. 2d 796 (1973). Relying upon *American Smelting & Refining Co.* v. *United States*, 130 F. 2d 883 (CA3 1942), and *Atchison, T. & S. F. R. Co.* v. *United States*, 443 F. 2d 147 (CA10 1971), the court held that the difference between the value of the preferred and the face amount of the debentures at the time of the exchange represented a discount or expense of borrowing, and qualified as an interest deduction to be properly amortized over the life of the debentures. We granted certiorari to resolve the indicated conflict. 414 U. S. 817 (1973).

II

The situation with which we are here concerned, therefore, is one where a taxpayer corporation issued debt obligations, namely, debentures, in exchange for its *own* outstanding preferred shares. It is not one where the taxpayer issued debt obligations in exchange for cash in an amount less than the obligations' face amount, or in exchange for property other than its own stock.

Section 163 (a), the short, pertinent part of which is set forth in n. 1, *supra*, is the statute NAD seeks to invoke in order to have the benefit of a deduction for what it claims is amortizable debt discount. The statute relates simply to "all interest paid or accrued within the taxable year on indebtedness." NAD's debentures obviously represented debt, and the stated 5% interest due semiannually on those debentures just as obviously would qualify as a deduction from gross income for NAD under § 163 (a). The issue here, however, is whether NAD is also entitled, in addition to the deduction for the

stated interest, to a further deduction, as "interest paid or accrued," for an appropriately amortized portion of the claimed $17 difference between the face amount of each $50 debenture and the value of each share of preferred on July 23, 1957.

Original-issue discount typically arises where an issuer sells its debt obligation on the market for *cash* at a price less than the face amount of the obligation. The difference, obviously, is the discount. A simple example is where a corporation issues its 6% $1,000 10-year bond for $950 cash. The corporation is obliged to pay and the bondholder is entitled to receive, the stated annual interest of 6%, or $60. That amount is deductible by the corporation and is includable in the payee's gross income as interest received. But the $50 difference between the face amount of the obligation and the issue price is an additional cost to the issuing corporation for the use of the money it is borrowing. That cost spread over the 10-year life of the bond amounts to $5 per year. Accepted accounting practice treats this discount as interest under § 163 (a).[6]

The Internal Revenue Code of 1939 and its predecessors did not provide explicitly for amortization and deduction of debt discount. The successive regulations, however, beginning with Art. 150 of Treasury Regulations 33 (revised 1918), issued under the Revenue Act of 1916, have provided for such amortization and deduction by the issuer.[7]

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[6] See H. Finney & H. Miller, Principles of Accounting, Intermediate 263 (6th ed. 1965); W. Meigs et al., Intermediate Accounting 683–688 (3d ed. 1974).

[7] Article 544 of Regulations 45, promulgated under the Revenue Act of 1918; Art. 545 (3) (a) of Regulations 62, 65, and 69, promulgated, respectively, under the Revenue Acts of 1921, 1924, and 1926; Art. 68 (3) (a) of Regulations 74 and 77, promulgated, respectively, under the Revenue Acts of 1928 and 1932; Art. 22 (a)–

The first statutory recognition of bond discount appeared in § 1232 (b)(1) of the 1954 Code. That section provides:

> "For purposes of subsection (a), the term 'original issue discount' means the difference between the issue price and the stated redemption price at maturity. . . ."

Section 1232 (b)(2) defines "issue price" in some detail.[8]

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18 (3)(a) of Regulations 86, 94, and 101, promulgated respectively, under the Revenue Acts of 1934, 1936, and 1938; and § 29.22 (a)–17 (3)(a) of Regulations 111, promulgated under the Internal Revenue Code of 1939. See *Montana Power Co.* v. *United States*, 232 F. 2d 541, 546-548 (CA3), cert. denied, 352 U. S. 843 (1956).

Under the 1954 Code, the relevant provision first appeared in the Income Tax Regulations as § 1.61–12 (c)(3) concerning gross income:

"If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. . . ."

Since the issuance of T. D. 6984, 1969–1 C. B. 38, this same language has appeared under the interest deduction provision in § 1.163–3(a)(1).

[8] The 1954 Code's § 1232 (b)(2) was amended by the Interest Equalization Tax Act, Pub. L. 88–563, § 5, 78 Stat. 845, and by the Tax Reform Act of 1969, Pub. L. 91–172, § 413 (b), 83 Stat. 611, applicable to bonds and other evidences of indebtedness issued after May 27, 1969. As so amended, the statute, in pertinent part reads:

"In the case of a bond or other evidence of indebtedness . . . [other than a bond or other evidence of indebtedness . . . issued pursuant to a plan of reorganization within the meaning of section 368 (a)(1) . . .], which is issued for property and which—

"(A) is part of an issue a portion of which is traded on an established securities market, or

"(B) is issued for stock or securities which are traded on an established securities market,

"the issue price of such bond or other evidence of indebtedness . . . shall be the fair market value of such property. Except in cases

This Court has recognized debt discount as an additional cost incurred in borrowing money. In *Helvering* v. *Union Pacific R. Co.*, 293 U. S. 282 (1934), in considering Article 150 of Regulations 33 (revised 1918), which described bond discount as a "loss" to be "prorated over the life of the bonds sold," the Court referred to discount not only as a loss but also as "interest paid for the use of capital procured by a bond issue." 293 U. S., at 286. More recently, in *United States* v. *Midland-Ross Corp.*, 381 U. S. 54 (1965), we clarified any ambiguity that may have resulted from the interest-loss approach when we stated, *id.*, at 57:

> "Earned original issue discount serves the same function as stated interest .... [I]t is simply 'compensation for the use or forbearance of money.' *Deputy* v. *du Pont*, 308 U. S. 488, 498."

It was also observed that,

> "despite some expressions indicating a contrary view, this Court has often recognized the economic function of discount as interest." *Id.*, at 66 (footnote omitted).

Accordingly, the discount may result ultimately in income to the purchaser,[9] but when amortized over the life of the obligation, it is deductible by the issuer.

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to which the preceding sentence applies, the issue price of a bond or other evidence of indebtedness . . . which is issued for property (other than money) shall be the stated redemption price at maturity."

Inasmuch as NAD's debentures were issued in 1957, the 1969 amendment is not applicable to the transaction.

[9] It was unsettled for some time whether income realized by an owner of an original discount obligation was taxable to that owner as ordinary income or as capital gain. In *Commissioner* v. *Caulkins*, 144 F. 2d 482 (CA6 1944), decided under the 1939 Code, it was held that gain upon surrender of an installment certificate issued at

While it is thus established that debt discount may ensue when a corporate debt obligation is issued at a discount for cash, this Court has never decided the question whether discount may result when debt obligations are issued in exchange for property other than cash. Those courts that have passed upon the issue have reached opposing conclusions. Compare *Nassau Lens Co.* v. *Commissioner*, 308 F. 2d 39 (CA2 1962); *American Smelting & Refining Co.* v. *United States*, 130 F. 2d 883 (CA3 1942); *Southern Fertilizer & Chemical Co.* v. *Edwards*, 167 F. Supp. 879 (MD Ga. 1955), to the effect that debt discount is available, with *Southern Natural Gas Co.* v. *United States*, 188 Ct. Cl. 302, 412 F. 2d 1222,

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a discount was capital gain. Other circuits, however, thereafter held that income attributable to the discount was ordinary income. See, for example, *Real Estate Investment Trust* v. *Commissioner*, 334 F. 2d 986 (CA1 1964), cert. denied, 381 U. S. 911 (1965); *Dixon* v. *United States*, 333 F. 2d 1016 (CA2 1964), aff'd, 381 U. S. 68 (1965); *United States* v. *Harrison*, 304 F. 2d 835 (CA5 1962), cert. denied, 372 U. S. 934 (1963); *Rosen* v. *United States*, 288 F. 2d 658 (CA3 1961); *Commissioner* v. *Morgan*, 272 F. 2d 936 (CA9 1959).

The issue was settled by the decision in *United States* v. *Midland-Ross Corp.*, 381 U. S. 54 (1965), when the Court held that earned original issue discount is not entitled to capital gain treatment under the 1939 Code.

Congress, in enacting § 1232 of the 1954 Code, adopted a different approach to earned original issue discount, referring to it as "a form of interest income" in S. Rep. No. 1622, 83d Cong., 2d Sess., 112 (1954). Under § 1232 (a)(2), gain from the sale or redemption of a corporate obligation issued at a discount is taxed as the gain from the sale of a noncapital asset. If the obligation is held by the original purchaser to maturity, the entire amount of the discount is so taxed, but if it is sold or redeemed before maturity, only the portion accrued up to the date of sale or redemption is so taxed. See De Kosmian, Original Issue Discount, 22 Tax Lawyer 339, 340–347 (1969); Zafft, Discount Bonds—Ordinary Income or Capital Gain?, 11 Tax L. Rev. 51 (1955).

1235–1239 (1969); *Montana Power Co.* v. *United States*, 141 Ct. Cl. 620, 159 F. Supp. 593, cert. denied, 358 U. S. 842 (1958); *Montana Power Co.* v. *United States*, 232 F. 2d 541 (CA3) (en banc),[10] cert. denied, 352 U. S. 843 (1956), to the effect that it is not available. This, of course, is a broader question than the one presented in the present case, and we need not, and do not, decide that broader issue. We are concerned, instead, only with the narrow issue whether debt discount arises where a corporate taxpayer issues an obligation in exchange for its own outstanding preferred shares.

In order properly to determine whether debt discount may be said to arise in such a situation, it becomes necessary to recognize the reason or factor that has been thought to justify the deduction. This has been the economic resemblance, in both form and function, which bond discount bears to stated interest for which the Revenue Acts and the Codes have allowed a deduction. Although, as has been noted, there has been some descriptive confusion in the regulations, with their references to "loss" as well as to "interest," and, as has also been noted, this Court, in *Helvering* v. *Union Pacific R. Co.*, 293 U. S., at 286, seemed to describe discount both as "interest paid for the use of capital" and as "loss resulting from the funding operation," the relevant inquiry in each case must be whether the issuer-taxpayer has incurred, as a result of the transaction, some cost or expense of acquiring the use of capital. It is to that inquiry we now turn.

III

It is NAD's position, of course, that amortizable bond discount arose on the exchange of its debentures for its

[10] Judge Kalodner, joined by Judge Staley, observed, "The American Smelting decision in that respect must be limited to its facts." 232 F. 2d, at 546.

outstanding preferred. It, and the Court of Appeals' majority, would look to what it calls the "economic realities" of the transaction in order to determine whether a cost of borrowing was incurred. The Court of Appeals likened the transaction to one where the corporation actually issued its $50 debenture for $33 in cash upon the open market (or to a holder of preferred) and then used that cash to purchase and retire outstanding preferred at $33 per share. 472 F. 2d, at 802. Upon such a transaction, it is claimed, there can be no question whatsoever that a deductible discount of $17 per debenture would result. It is argued that to deny similar treatment to the transaction which did take place, where a direct exchange was made with the preferred shareholder, would require a corporate taxpayer in the future to engage in a complex and expensive series of securities transactions in order to establish its entitlement to a deduction.

This argument, however, calls upon this Court to take two steps that we are reluctant and unwilling to take. First, it would require rejection of the established tax principle that a transaction is to be given its tax effect in accord with what actually occurred and not in accord with what might have occurred. Second, it would require us to speculate about the market price and value to the corporation of the debentures in question had they been sold upon the open market.

Even if we were to assume, *arguendo*, that the hypothetical transaction posed by the taxpayer and the Court of Appeals was indistinguishable, as a matter of economic reality, from what actually occurred, we would not be required, for that reason alone, to recognize a claimed deduction for debt discount. The propriety of a deduction does not turn upon general equitable considerations, such as a demonstration of effective economic and practi-

cal equivalence. Rather, it "depends upon legislative grace; and only as there is clear provision therefor can any particular deduction be allowed." *New Colonial Ice Co.* v. *Helvering*, 292 U. S. 435, 440 (1934); *Deputy* v. *Du Pont*, 308 U. S. 488, 493 (1940). This Court has observed repeatedly that, while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not, *Higgins* v. *Smith*, 308 U. S. 473, 477 (1940); *Old Mission Portland Cement Co.* v. *Helvering*, 293 U. S. 289, 293 (1934); *Gregory* v. *Helvering*, 293 U. S. 465, 469 (1935), and may not enjoy the benefit of some other route he might have chosen to follow but did not. "To make the taxability of the transaction depend upon the determination whether there existed an alternative form which the statute did not tax would create burden and uncertainty." *Founders General Corp.* v. *Hoey*, 300 U. S. 268, 275 (1937); *Television Industries, Inc.* v. *Commissioner*, 284 F. 2d 322, 325 (CA2 1960); *Interlochen Co.* v. *Commissioner*, 232 F. 2d 873, 877 (CA4 1956). See *Gray* v. *Powell*, 314 U. S. 402, 414 (1941).

Both the rationale and the wisdom of the Court's attitude toward such attempts at reconstruction of transactions are particularly well demonstrated in the present case. In the absence of any actual or even attempted sales of debentures or purchases of the preferred by NAD in the open market, the Court is called upon to speculate as to what the market price and the investor reaction to such events would have been. There are several reasons why we cannot do this:

First, there is nothing in the record establishing the cash price at which the debentures could have been sold upon the market had they been offered for sale. The current rate for money and the credit status of the bor-

rower are pertinent factors in the determination of discount (or premium) on an open market, as contrasted with a closed transaction.

Second, there is also nothing in the record to indicate that NAD would have been able to purchase all its outstanding preferred on the open market, or at what price that quantity of stock would have been purchased in light of the impending exchange. See *Gulf, M. & O. R. Co.* v. *United States*, 339 F. Supp. 489 (SD Ala. 1972), final decision 31 A. F. T. R. 2d 73–436 (1972), pending on appeal to CA5 and deferred awaiting the decision in this case; *Cities Service Co.* v. *United States*, 316 F. Supp. 61 (SDNY 1970), 362 F. Supp. 830 (SDNY 1973), appeal to CA2 pending. The stipulated over-the-counter quotations, set forth in n. 4, *supra*, and in the cited National Stock Summary, are quotations only for what at most was a thin market, and were hardly representative of the fair market value of the entire 47,059 preferred shares outstanding. The preferred's redemption price at the time was $51 plus the arrearage, or a total of $61, almost double the claimed $33 per share.

Third, when a corporation issues to its preferred shareholders its own new debt obligations in exchange for outstanding preferred, the claimed fair market value of both securities is somewhat artificial since the exchange is effectively insulated from market forces by the intracorporate and private nature of the transaction. See *Missouri Pacific R. Co.* v. *United States*, 192 Ct. Cl., at 324–325, 427 F. 2d, at 730–731. The economics underlying discount is that it is an adjustment of the difference between the interest prescribed in the instrument issued and the prevailing market rate for money, and it arises because the prescribed rate is too low to sell the obligations at par in that market. See *San Joaquin Light & Power Corp.* v. *McLaughlin*, 65 F. 2d 677, 679 (CA9

1933). Thus, implicit in the concept of debt discount is the assumption, and indeed the requirement, that the transaction be subject to the exigencies of the competitive money market.

Here, there has been no demonstration that the difference between the claimed $33 per share value of NAD's preferred (laying aside for the moment the aforementioned difficulties in arriving at that determination) and the face amount of the debentures is attributable to debt discount. As the Tax Court noted, 57 T. C., at 52 n. 6, there is no evidence of what the fair market value of the bonds was at the time of their issuance. Other factors that would have to be considered would include NAD's financial condition at the time of the exchange, including both its credit position and its profits prospects, and the availability and cost of capital in the general market as well as from its preferred shareholders. Normally, the market itself performs this evaluative process. Aside from the fact that the transaction was insulated from the market processes, there has been no attempt here to show that the discount rate was determined with a view toward accounting for these several factors rather than simply having been predicated on the par value of the preferred. Accordingly, the requisite evaluation of the property to be exchanged cannot occur in this intracorporate transaction and debt discount cannot be determined. Cf. *Gulf, M. & O. R. Co.* v. *United States, supra; Southern Fertilizer & Chemical Co.* v. *Edwards*, 167 F. Supp., at 881.

IV

It has not been demonstrated that NAD, by the exchange, incurred any additional cost for the use of capital. NAD merely replaced that portion of its paid-in capital represented by its preferred with paid-in capital represented by its debentures. From the perspective of the

corporation, the transaction was the exchange of one form of interest or participation in the corporation for another. But the corporate assets were neither increased nor diminished.[11]

To be sure, upon the issuance of its debentures, NAD assumed a fixed obligation to pay at a date certain. The transaction, therefore, perhaps could be said to be something more than a mere reshuffling of the corporation's capital structure, see *Helvering* v. *Southwest Consolidated Corp.*, 315 U. S. 194, 202 (1942), since a creditor was substituted for a holder with an ownership interest.[12] But again, when viewed from the corporation's perspective, and regardless of the income tax effect upon the former preferred shareholder, which we deem to be irrelevant, there has been no new capital acquired and no additional cost incurred in retaining the old capital. See *St. Louis-S. F. R. Co.* v. *United States*, 195 Ct. Cl. 343, 350, 444 F. 2d 1102, 1106 (1971), cert. denied, 404 U. S. 1017 (1972).

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[11] In *Old Mission Portland Cement Co.* v. *Helvering*, 293 U. S. 289 (1934), where original issue discount bonds were held by an affiliate of the issuing corporation, the Court concluded that a deduction for the discount was not available when the affiliated corporations filed a consolidated income tax return. The situation was related to that of a single taxpayer purchasing its own bonds prior to maturity. Because, viewing the affiliates as a single taxpaying entity, there was no obligation to pay the face amount at maturity, the issuer "could not afterwards deduct, from gross income, the amortized discount on the bonds, in anticipation of their payment at maturity." *Id.*, at 292. Here NAD incurred no additional obligation because of the substitution of its debentures for its preferred.

[12] While in no sense implying that the securities were equivalent, the Court in the past has noted that the investment difference between preferred shares and unsecured debentures can be of slight degree, and is further diminished when, as here, the debentures are subordinated. *John Kelley Co.* v. *Commissioner*, 326 U. S. 521 (1946).

In obvious explanation of this, NAD originally received $50 cash for each share of preferred. Although it was not obligated to repay that sum at any fixed time, it made use of that cash pursuant to the provisions of its articles, including both the sinking fund and the redemption-liquidation provisions. Upon the exchange, the corporation canceled the preferred, and thus eliminated the preferred stock account upon its books, together with the preferred's attendant obligations. The market value of the preferred at that moment bore no direct relationship to the amount of funds on hand. The capital "freed" by the cancellation of the preferred was merely transferred to the liability account for the debentures. No new capital was involved. See *Claussen's, Inc.* v. *United States*, 469 F. 2d 340 (CA5 1972).[13]

It is true that there was some change in the corporate structure. Henceforth, NAD would receive a deduction for interest paid on the debentures, whereas the 5% dividend paid on the preferred had not been deductible. The common shareholders were benefited by the elimination of the dividend arrearages on the preferred and by the elimination of the premium payable on the preferred's retirement. Yet the change was not great. The fixed interest on the debentures was equal to the cumulative dividend on the preferred, and both the preferred and

[13] "We simply cannot overlook the complete lack of substance to the claims of the corporation here. Its assets were not diminished by a penny, either when the debentures were issued to the stockholders or where the face amount of the bonds was assumed by Fuqua (thus, presumably reducing the amount of the purchase price). The company paid nothing more to the bond-holders at any time than the current interest. It did not sell them to anyone at a discount. It issued them either as dividend, partial distribution of earned income and capital, or as 'boot' in a tax-free reorganization. It cannot deduct as interest what it has not paid out or become liable to pay out to anybody." 469 F. 2d, at 344 n. 11.

the debentures worked equal diminutions in the earnings otherwise available for the common shareholders. The debentures, of course, were to mature in 1975, but the sinking fund provisions for both the preferred and the debentures were comparable. Thus, the interest of the preferred shareholders "was fairly reflected in the highly equivalent characteristics of the debentures into which the preferred was converted." *Penfield* v. *Davis*, 105 F. Supp. 292, 311 (ND Ala. 1952), aff'd, 205 F. 2d 798 (CA5 1953). The cost of the capital invested in the corporation was the same whether represented by the preferred or by the debentures, and was totally unaffected by the market value of the shares received at the time of the issuance of the debentures. Accordingly, while recognizing the alteration which did occur in the corporation's capital structure, we conclude that the substitution by NAD of its debentures for its previously outstanding preferred, without more, did not create an obligation to pay in excess of an amount previously committed, or establish the base upon which debt discount can arise.

In sum, the alteration in the form of the retained capital did not give rise to any cost of borrowing to NAD. The fact that the preferred may have been worth something in the neighborhood of only $33 per share on the market at the time of the exchange was of no consequence, since NAD was not required to go into that market and purchase those shares. It was able, instead, to obtain the preferred merely by canceling the $50 obligation per share on its equity account and transferring that amount to its debt account. It is in this sense that an exchange of a corporation's own outstanding preferred for newly issued debt obligations may differ, in the tax sense, from an exchange for other property. Such other property—for example, inventory or the stock

of another corporation—does not equate with a previous contribution of capital which can continue to be utilized by the corporation at no cost upon cancellation of the preferred equity account.

We hold, accordingly, that NAD did not incur amortizable bond discount upon the issuance of its $50 face value 5% debentures in exchange for its outstanding $50 par cumulative preferred stock. The judgment of the Court of Appeals is reversed.

It is so ordered.

Mr. JUSTICE STEWART concurs in the judgment and in Parts I, II, and III of the Court's opinion.